JUL 28 1986 COMPLETED Y 1.1/8: 99-676

Union Calendar No. 403

99th Congress, 2d Session - - - - - - - - - - - - House Report 99-676

ORIGINAL

FEDERAL REGULATION OF BROKERED DEPOSITS: A FOLLOWUP REPORT

THIRTY-EIGHTH REPORT

BY THE

COMMITTEE ON GOVERNMENT OPERATIONS

together with

ADDITIONAL VIEWS

JULY 16, 1986.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

---

U.S. GOVERNMENT PRINTING OFFICE

61-417 O WASHINGTON : 1986

CDD I BEST COPY AVAILABLE

COMMITTEE ON GOVERNMENT OPERATIONS

JACK BROOKS, Texas, *Chairman*

DON FUQUA, Florida
JOHN CONYERS, Jr., Michigan
CARDISS COLLINS, Illinois
GLENN ENGLISH, Oklahoma
HENRY A. WAXMAN, California
TED WEISS, New York
MIKE SYNAR, Oklahoma
STEPHEN L. NEAL, North Carolina
DOUG BARNARD, Jr., Georgia
BARNEY FRANK, Massachusetts
TOM LANTOS, California
ROBERT E. WISE, Jr., West Virginia
BARBARA BOXER, California
SANDER M. LEVIN, Michigan
MAJOR R. OWENS, New York
EDOLPHUS TOWNS, New York
JOHN M. SPRATT, Jr., South Carolina
JOE KOLTER, Pennsylvania
BEN ERDREICH, Alabama
GERALD D. KLECZKA, Wisconsin
ALBERT G. BUSTAMANTE, Texas
MATTHEW G. MARTINEZ, California

FRANK HORTON, New York
THOMAS N. KINDNESS, Ohio
ROBERT S. WALKER, Pennsylvania
WILLIAM F. CLINGER, Jr., Pennsylvania
ALFRED A. (AL) McCANDLESS, California
LARRY E. CRAIG, Idaho
HOWARD C. NIELSON, Utah
JIM SAXTON, New Jersey
PATRICK L. SWINDALL, Georgia
THOMAS D. (TOM) DeLAY, Texas
JOSEPH J. DioGUARDI, New York
RICHARD K. ARMEY, Texas
JIM LIGHTFOOT, Iowa
JOHN R. MILLER, Washington
BEAU BOULTER, Texas
JOHN E. GROTBERG, Illinois

WILLIAM M. JONES, *General Counsel*
STEPHEN M. DANIELS, *Minority Staff Director and Counsel*

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

DOUG BARNARD, Jr., Georgia, *Chairman*

JOHN M. SPRATT, Jr., South Carolina
JOE KOLTER, Pennsylvania
BEN ERDREICH, Alabama
ALBERT G. BUSTAMANTE, Texas

LARRY E. CRAIG, Idaho
PATRICK L. SWINDALL, Georgia
JIM SAXTON, New Jersey

EX OFFICIO

JACK BROOKS, Texas

FRANK HORTON, New York

PETER S. BARASH, *Staff Director*
THEODORE J. JACOBS, *Chief Counsel*
DONALD P. TUCKER, *Chief Economist*
STEPHEN R. McSPADDEN, *Counsel*

BEST COPY AVAILABLE

LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
Washington, DC, July 16, 1986.

Hon. THOMAS P. O'NEILL, Jr.,
Speaker of the House of Representatives,
Washington, DC.

DEAR MR. SPEAKER: By direction of the Committee on Government Operations, I submit herewith the committee's thirty-eighth report to the 99th Congress. The committee's report is based on a study made by its Commerce, Consumer, and Monetary Affairs Subcommittee.

JACK BROOKS, *Chairman.*

BEST COPY AVAILABLE

BLANK PAGE

CONTENTS

	Page
I. Introduction and recent developments	1
A. Background	2
B. Proposed recordkeeping rules	3
C. Recent FDIC views	5
D. Recent FHLBB views	6
E. Special failure cases: Linked financing	7
II. Recent information on the role of brokered deposits in banks and thrifts	8
A. Quantity and role of brokered deposits in large troubled banks	8
B. Fully insured brokered deposits in troubled banks—GAO tabulations	9
C. Brokered deposits in failed banks, 1982–85	10
D. Role of brokered deposits among selected problem S&L's	11
E. FHLBB enforcement of brokered deposits limitation in institutions with low net worth	11
F. Brokered funds growth in problem S&L's, March 31 to September 30, 1984	12
III. Findings	13
A. Summary	13
B. Commercial banks	13
1. Brokered deposits in recently failed banks	13
2. Role of brokered deposits in large troubled banks	14
3. Insured brokered deposits in sound banks	14
4. Individual abuses	15
5. Brokered volume in smaller troubled banks	15
6. Linked financing	15
7. Recordkeeping proposal	15
8. FDIC misrepresentation	16
C. Savings and loan associations	17
1. Positive role for brokered deposits in troubled institutions	17
2. Ineffectiveness for controlling growth	17
3. Net worth rule	17
4. Linked financing	17
5. Enforcement	17
IV. Recommendations	18
1. Concentrate just on specific abuses	18
2. Linked financing	18
3. Deposit diversification	18
4. Recordkeeping	18
5. FHLBB net worth rule	18

TABLES

Table 1-A.—Fully insured brokered deposits in FDIC-insured banks reporting at least 5 percent insured brokered deposits, March 31 and June 30, 1985	19
Table 1-B.—Fully insured brokered deposits in national banks reporting at least 5 percent insured brokered deposits, March 31 and June 30, 1985	19
Table 2.—Role of brokered funds in FDIC-insured commercial bank failures, 1982–85	20
Table 3.—Brokered deposits in failed commercial banks, 1985	20

BEST COPY AVAILABLE

APPENDIXES

Page
Appendix 1 23
Appendix 2 32

ADDITIONAL VIEWS

Additional views of Hon. Larry E. Craig 48

BEST COPY AVAILABLE

Union Calendar No. 403

99TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
99-676

FEDERAL REGULATION OF BROKERED DEPOSITS: A FOLLOWUP REPORT

JULY 16, 1986.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. BROOKS, from the Committee on Government Operations, submitted the following

THIRTY-EIGHTH REPORT

together with

ADDITIONAL VIEWS

BASED ON A STUDY BY THE COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

On June 24, 1986, the Committee on Government Operations approved and adopted a report entitled "Federal Regulation of Brokered Deposits: A Followup Report." The chairman was directed to transmit a copy to the Speaker of the House.

I. INTRODUCTION AND RECENT DEVELOPMENTS

In September 1984 the Government Operations Committee issued a report on Federal regulation of brokered deposits, based upon a hearing held by the Commerce, Consumer, and Monetary Affairs Subcommittee in March 1984 and upon extensive additional statistical materials gathered by the subcommittee. The report criticized as both harmful and ineffective the recently issued rule of the FDIC and Federal Home Loan Bank Board severely restricting the deposit insurance coverage of brokered deposits.[1] This supplementary report presents new factual background, findings, and recom-

[1] "Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions," House Report 98-1112 (Committee on Government Operations Report No. 52), September 28, 1984.

61-417 O

BEST COPY AVAILABLE

mendations based upon events and subcommittee investigation subsequent to the September 1984 report.

A. BACKGROUND

In 1982 and 1983 a substantial number of bank and thrift failures occurred in which brokered deposits were prominently involved. The deposit insurance funds (FDIC and FSLIC) found that in some of these cases the brokered funding obtained by the institutions prior to their failures increased the costs to the insurance funds and may have even caused the failures. The agencies also observed other problem institutions which had not failed but whose problems seemed to have occurred as a result of bad loans or investments made with funds from brokered deposits.

In response to these problems, the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank Board (FHLBB), in a joint rulemaking action, issued a rule in March 1984 that would have effectively eliminated the insured deposit brokerage business. This rule provided that deposit insurance coverage would be limited, beginning October 1, 1984, to no more than $100,000 for all deposits placed in a single bank or thrift institution by a single deposit broker, without regard to who the beneficial owners of the funds were or how much of the broker's total belonged to each beneficial owner.[2]

The agencies' rule was immediately challenged in Federal district court, which found that the agencies had exceeded their statutory authority. In early 1985 a Federal appeals court upheld the district court decision and denied agency requests for a rehearing. Consequently, the rule was never implemented, although the uncertainty that prevailed about its possible implementation imposed a temporary chill upon the deposit brokerage business.

This initial failure in their attempt to discourage insured deposit brokerage through restrictive regulation has led the agencies to seek other controls on brokered funds, through both legislation and different regulatory initiatives. The Federal Home Loan Bank Board issued a rule in March 1984 to restrict the acquisition of additional brokered deposits by FSLIC-insured institutions whose net worth was less than 3 percent of liabilities.[3] Then in December 1984 the FDIC imposed a monthly reporting requirement for all FDIC-insured institutions whose combined total of fully insured brokered deposits and fully insured deposits placed by other depository institutions exceeded 5 percent of total deposits. These reports enable the FDIC to monitor more effectively the flows of insured brokered funds into individual institutions.[4]

In addition, both agencies issued proposed rules for public comment that would have required each depository institution to main-

---

[2] "Brokered Deposits; Limitations on Deposit Insurance," FDIC and FHLBB final rule, Federal Register, April 2, 1984, pp. 13003–12.

[3] "Brokered Deposits; Limitations Applicable to Institutions With Low Net Worth," Federal Home Loan Bank Board interim final rule, Federal Register, April 2, 1984, pp. 13012–4; clarified in Federal Register, April 30, 1984, pp. 18282–3. On January 31, 1985, the rule was reissued in final form: "Brokered Deposits; Limitations Applicable to Institutions With Low Net Worth," final rule, Federal Register, February 7, 1985, pp. 5232–4.

[4] "Reporting Requirements on Deposits Placed by Deposit Brokers and Depository Institutions," FDIC final rule, Federal Register, December 17, 1984, pp. 48906–9.

tain complete records internally of the beneficial owners of all insured brokered balances.[5] While the FDIC proposal has recently been withdrawn, the Bank Board proposal still remains under consideration.

The agencies' efforts on this subject have been accompanied, moreover, by repeated assertions about the pernicious effects of insured deposit brokerage and the serious need for tougher restrictions. The testimony given by former FDIC Chairman Isaac and FHLBB Chairman Gray before the House Banking Subcommittee on General Oversight and Investigations on July 16, 1985, presented strong restatements of this viewpoint.

The two agencies' position has been based in part on their experience with certain individual bank and thrift failures in which the loans that ultimately went bad and caused the failures had been granted initially through prior arrangement with one or more deposit brokers in what are frequently known as "linked financing" arrangements. The agencies have offered these cases as illustrations of the detrimental impact of deposit brokers on the banking system.

Because of the continued agency efforts to curtail insured deposit brokerage, and the related congressional interest in the subject of brokered deposits, the Commerce, Consumer, and Monetary Affairs Subcommittee has pursued further investigation and analysis of brokered deposits usage and the need for the restrictions advocated by the agencies. An important part of the subcommittee's work has been to arrange for compilation of extensive additional data on the distribution of brokered deposits among problem and nonproblem institutions. This report presents the subcommittee's principal additional findings and recommendations based on the events that have occurred and the compilations of data that have become available since the September 1984 report.

B. PROPOSED RECORDKEEPING RULES

The recordkeeping rule proposed by the FDIC provided that ". . . no claim for insurance coverage based on an ownership interest in deposit accounts maintained by a 'deposit broker' will be recognized unless the identities of the owners of such interests and the amount of those interests are disclosed on the records of the bank." [6]

Under present rules, the names of the beneficial owners of deposits placed through deposit brokers need not be on record at the banks as long as the brokers maintain such records, and this is a fairly common practice. Certain brokers, especially the large securities brokers whose brokered deposits clientele includes individual investors, often aggregate together the deposits of many customers into a single jumbo CD deposit at a certain bank or thrift, rather than establishing a separate deposit account for each customer.

These brokerage houses also maintain internally a secondary market for the individual CD's purchased by their retail customers,

---

[5] "Recordkeeping Requirements for Deposits Placed by Deposit Brokers," FDIC proposed rule, Federal Register, August 2, 1985, pp. 31380-3; and "Settlement of Insurance," Federal Home Loan Bank Board proposed rule, Federal Register, May 7, 1985, pp. 19185-96.

[6] FDIC proposed recordkeeping rule, op. cit., p. 31382.

so that a customer who invests funds in a 30-month CD (for example) can sell it after 3 or 6 months if necessary to obtain access to his or her funds. The recordkeeping rule would require that ownership changes occurring through this secondary market activity be recorded on the records of the issuing bank.

In explaining the need for this rule change, the FDIC laid particular emphasis on the need to limit potential fraud and evasion of the insurance limits through deposit brokers. Other reasons stated for this rule were that it would enable the FDIC to assess more accurately and quickly its insurance exposure in failed banks, thereby facilitating their resolution.

Strong objections were raised against this proposal by the securities brokerage industry, the American Bankers Association, and several large banks. The proposed rule was generally supported by a number of small banks that commented, as well as by the Independent Bankers Association.

Merrill Lynch, for example, commented that the rule was unnecessary to prevent fraud and that "the FDIC has failed to recognize the extent to which, under current industry practices and existing [SEC] regulations, the information the FDIC seeks is already available to insured institutions." Merrill Lynch and many other commenters also asserted that the proposed rule would unnecessarily curtail secondary trading in the CD's of banks. The Merrill Lynch letter then proposed other less burdensome approaches for assuring that the FDIC would have timely access, when needed, to the complete ownership records on brokered deposits.

A letter of opposition was also submitted by the then Acting Comptroller of the Currency H. Joe Selby, who served ex officio at that time as one of the three members of the FDIC Board of Directors. His letter stated that ". . . the proposal, in its current form, would result in a severe disruption in the secondary market for insured banks' negotiable certificates of deposits." He went on to propose concrete alternatives for assuring the FDIC improved access to information on the beneficial owners of brokered deposits, which he felt would address adequately the FDIC's problem.[7]

The Federal Home Loan Bank Board's proposal on brokered deposits recordkeeping was part of a comprehensive revision of the rules regarding settlement of insurance in cases of liquidation of FSLIC-insured thrifts. In explaining the need for the new recordkeeping provisions the FHLBB stated:

> . . . in the course of the insurance settlement process the FSLIC now often faces the immensely complicated and time-consuming task of investigating many large-denomination accounts in depth. The time spent on the settlement of such accounts significantly slows the whole insurance settlement process, to the detriment of all accountholders seeking speedy payment of insurance. The complexity of the arrangements used, together with the large amounts in question, also dramatically increase the possibility of post-default invention of relationships and other fraudulent devices.[8]

---

[7] H. Joe Selby letter to FDIC Executive Secretary Hoyle Robinson, September 6, 1985.
[8] FHLBB proposed recordkeeping rule, op. cit., p. 19188-9.

The Bank Board's proposal was strongly opposed by many commenters for the same reasons as were cited for opposing the FDIC rule. Opposition was expressed by several major brokerage houses, the U.S. League of Savings Institutions, and most of the thrift institutions that commented, with particular emphasis being placed on the points that this proposal would cause unnecessary duplication of effort and serious impairment of the secondary market in thrift CD's.

With regard to the Bank Board's argument about the need to reduce the possibility of fraud, some comments challenged the basis for this on the ground that the Bank Board cited no examples of fraud and asserted no experience of actual fraud to support its position.

C. RECENT FDIC VIEWS

Former FDIC Chairman Isaac testified at length on brokered deposit problems in commercial banks in the hearing held by the Subcommittee on General Oversight and Investigations on July 16, 1985. His principal theme was that insured brokered funds are used mostly by institutions in trouble and have been prominently involved in many bank failures since the beginning of 1982. "There is no question that use of brokered funds in these [failed] banks has cost the FDIC hundreds of millions of dollars," he reported.[9]

On the use of brokered funds by sound institutions, Mr. Isaac, in response to questioning from Mr. Barnard, responded as follows:

> Mr. ISAAC. . . . I have no problem with brokered deposits whatsoever. I don't want to outlaw them. I just don't want to insure them. I want them to go to the banks and thrifts that are creditworthy.
>
> Mr. BARNARD. Don't they do that in the great majority?
>
> Mr. ISAAC. No; not if they are insured. . . . The bulk of the fully insured funds are going to troubled institutions.[10]

Mr. Isaac also reiterated his position that without access to fully insured brokered funds, it is very difficult for institutions, and especially difficult for weak problem institutions, to attract funds for rapid growth.[11] Consequently, he argued, a tight restriction on insured deposit brokerage would effectively prevent the kind of runaway deposit growth often seen in weak institutions trying to make a fast buck. He said he felt that a legislative cap limiting insured brokered funds to no more than a bank's capital would be an adequate restriction.[12]

The size of the problem is reflected, he stated, in the fact that troubled banks (those having supervisory CAMEL ratings in the three poorest classes) held over $9 billion of brokered funds in an FDIC survey conducted in 1984. A later survey conducted in Febru-

---

[9] Prepared statement of FDIC Chairman Isaac for Subcommittee on General Oversight and Investigations, July 16, 1985, p. 4.

[10] "Impact of Brokered Deposits on Banks and Thrifts: Risks Versus Benefits," hearing before Subcommittee on General Oversight and Investigations, Committee on Banking, Finance, and Urban Affairs, July 16, 1985, p. 83.

[11] Ibid., p. 85.

[12] Isaac prepared statement, op. cit., p. 10.

BEST COPY AVAILABLE

ary 1985, which was limited just to institutions having fully insured brokered deposits in excess of 5 percent of their total deposits, found $2.3 billion of fully insured brokered funds in over 70 troubled banks.[13]

In order to characterize the brokered funds problem more fully, former Chairman Isaac also reported to the Oversight Subcommittee the names of the 25 largest suppliers of fully insured brokered deposits to troubled FDIC-insured institutions, as determined by the February 1985 survey. Heading the list, and accounting for 75 percent of the $2.1 billion attributed to the top 25 suppliers of brokered funds, were five major stock brokerage firms: Merrill Lynch, Dean Witter Reynolds, Prudential Bache, First Boston, and Goldman Sachs.[14]

Finally, his statement to the Oversight Subcommittee described six case studies of individual failed banks that had used brokered funds. These are described in more detail in section E below.

D. RECENT FHLBB VIEWS

Federal Home Loan Bank Board Chairman Edwin Gray also presented a statement before the General Oversight Subcommittee's hearing on July 16. He emphasized the same theme that deposit brokers contribute to institution failures by making it extremely easy for aggressive institutions to raise funds in very large quantities for speculative investments that often go bad. Those who believe the money brokers "were simply innocent bystanders, harmless participants in the death dance of failed and failing institutions, . . . are likely to believe in fairy tales," he asserted.[15]

He went on to cite examples, including in particular Empire Savings of Mesquite, Texas, and San Marino Savings in California, both of which had relied heavily on brokered deposits to grow at extremely rapid rates prior to their failures. Among remaining problem institutions that had not yet failed, he stated that over 50 percent of these institutions involve high levels of brokered funds.

While acknowledging that the FHLBB had curtailed the problem to some degree through new regulatory efforts, he insisted that "the heart of the problem and its potential for further mischief continues."[16]

The preferred solution to this problem, he stated, would be for Congress to grant the FHLBB the authority to classify insurance of accounts. By this he meant the authority to deny deposit insurance to specific classes of deposits, which the agency would be expected to use to deny insurance coverage to brokered deposits. The next best solution, he stated, would be to impose a 5-percent limit on the amount of brokered funds any institution could have as a percent of its total deposits.[17]

Chairman Gray also expressed detailed views on the problem of brokered deposits, although with a somewhat different emphasis, in

---

[13] Ibid., pp. 3, 5.
[14] Isaac prepared statement, op. cit., p. 6 and Schedule C.
[15] Prepared statement of FHLBB Chairman Gray for Subcommittee on General Oversight and Investigations, July 16, 1985, p. 3.
[16] Ibid., p. 7.
[17] Ibid., p. 14.

a recent letter to Mr. Barnard.[18] In this letter he emphasized the vulnerability of insured institutions to being enticed or coerced by deposit brokers to make certain loans favorable to the broker or his associates as a condition for the placement or renewal of brokered balances. Such "linked financing" arrangements, which are not prohibited, often lead institutions into unsound loans or speculative investments, he asserted.

He acknowledged that a clamp just on brokered funds would not be wholly effective in preventing institutions from growing too rapidly, since the aggressive institutions are able to raise funds in other ways. Thus he appeared to be reducing the importance he attached to the need for brokered funds constraints as a way to prevent excessively rapid growth. For rapidly growing institutions, however, he asserted that money desk operations or other nonbrokered sources of funds are preferable to brokered funds since they provide an element of diversification to the funding, so that the institutions are less vulnerable to becoming involved with linked financing deals.

Chairman Gray, in response to Mr. Barnard's earlier inquiry about the apparent inability of the FHLBB to secure compliance with its rule limiting the brokered funds of institutions with low net worth, particularly at Beverly Hills Savings and Loan prior to its failure, also acknowledged the continuing supervisory problems of the agency in obtaining compliance with agency rules by certain institutions. He then asked for legislation to expand their enforcement powers to permit them to restrain recalcitrant institutions more effectively.

E. SPECIAL FAILURE CASES: LINKED FINANCING

In a series of three articles in November 1984 and a subsequent article in December 1984 the American Banker reported on the role of First United Fund, a deposit broker located in Garden City, NY, in setting up linked financing transactions with various banks several of which later failed. Principal attention in these articles was given to the affairs of the Indian Springs State Bank, of Kansas City, KS, which was closed in January 1984 with $9.3 million of brokered funds out of a total of $27 million in deposits, of which about $6 million had been provided by First United Fund. Under the linked financing arrangement with First United Fund, Indian Springs had provided $3.7 million in highly speculative loans to certain individuals to invest in real estate partnerships in Hawaii. The bank was closed when these loans went into default.[19]

The articles went on to identify by name several other institutions that failed after obtaining brokered deposits from First United Fund and to report that Federal officials were investigating the extent to which these other institutions also made specific linked financing loans arranged by First United. First United

---

[18] Federal Home Loan Bank Board letter of October 18, 1985, included as appendix 1 of this report.

[19] "How Financings Linked to Brokered Deposits Entice Some Banks into Disastrous Loan Deals," "A Tale of Brokered Deposits and a Busted Bank," and "Attempts to Save Indian Springs Were Too Late to Overcome Bad Loans and Brokered Deposits," by Richard Ringer and Bart Fraust, American Banker, November 15, 16, and 19, 1984; "Investigation of Linked Financing Deals Grows," by Richard Ringer, American Banker, December 17, 1984.

BEST COPY AVAILABLE

Fund's offices were searched and records seized by the Justice Department's Organized Crime Strike Force in October 1984 shortly after the closing of the Rexford State Bank of Rexford, KS, which had also expanded very rapidly with brokered funds from First United.

Later American Banker articles reported linked financing loans made with brokered funds from First United had caused the failure of the Farmers State Bank of Selden, KS, and the severe deterioration of the Coronado Federal Savings and Loan Association of Kansas City, KS.

The FDIC has subsequently filed a civil racketeering lawsuit against First United Fund charging the fund, its president, and other affiliated persons with contributing to the failure of Indian Springs, and this suit has recently been amended to include charges related to the failure of Rexford as well. The FDIC is also considering lawsuits against other brokers in connection with certain other failures, reflecting the FDIC's belief that these brokers may have actively sought to defraud the banks in which they placed funds.

In order to illustrate the interconnection between brokered deposits and bank failures, former FDIC Chairman Isaac's statement to the General Oversight Subcommittee included an appendix describing six case studies of failed banks that had used brokered funds, three of which he described as having engaged in linked financing schemes arranged with the money brokers. Indian Springs was one of these, but Farmers State Bank, which was another of the six, was not reported as having been engaged in linked financing, contrary to the earlier newspaper story. The other three case studies cited by Mr. Isaac had employed their brokered funds for $6 million in fraudulent insurance premium financing contracts, a worthless $10 million insurance company annuity contract, and what the FDIC described as bogus loans.[20] All six banks cited were small, with the largest, Community Bank of Hartford, SD, having $39 million in total deposits.

II. Recent Information on the Role of Brokered Deposits in Banks and Thrifts

A. Quantity and Role of Brokered Deposits in Large Troubled Banks

In characterizing the magnitude of the brokered deposits problem in FDIC-insured banks, former FDIC Chairman Isaac referred several times in his public statements on the deposit brokerage problem to the presence of over $9 billion of brokered funds in "troubled" institutions, meaning those with supervisory CAMEL ratings of 3 or worse.[21] Data obtained from the FDIC for preparation of this committee's September 1984 report showed that, as of March 31, 1984, there was less than $600 million of brokered funds in smaller problem institutions (rated 4 or 5 and having deposits of less than $1 billion).[22] It thus appeared that a very high percent-

[20] Isaac prepared statement, op. cit., Schedule B.

[21] Banks rated 3 on the CAMEL scale receive increased supervisory attention, while 4- and 5-rated banks are the "problem" banks.

[22] Report, op. cit., table 2, p. 24.

age of the $9 billion in "troubled" institutions cited by Mr. Isaac was in billion-dollar institutions, which had never been identified as abusive users of brokered funds.

Accordingly, in order to clarify the significance of the $9 billion figure, the three bank regulatory agencies were asked to provide information on the volume, insurance status, and interest cost of brokered deposits held by troubled billion dollar institutions. In addition, they were asked whether their respective bank examiners had found any connection between the use of brokered deposits by these large banks and the problem loans or other difficulties that caused their poor CAMEL ratings.

In response to this inquiry, the Comptroller of the Currency reported that $8 billion of brokered funds (as of September 30, 1984) was in large troubled national banks having over $1 billion in domestic deposits each, and that only an estimated $2 billion of this was insured. The Comptroller reported, moreover, that there was no relevant connection between the brokered source of these funds and the banks' problem status.

Greater detail on the subcommittee request and the agencies' responses, including the text of the Comptroller's letter, is in a memorandum that appears as appendix 2 to this report.[23]

B. FULLY INSURED BROKERED DEPOSITS IN TROUBLED BANKS—GAO TABULATIONS

Although the call reports filed by all banks every 3 months include the dollar amounts of total brokered deposits, they do not provide reliable information on the quantity of insured brokered funds in the banks. In order to obtain more reliable and timely information on the use of insured brokered funds by banks, which are the only component the agencies have been trying to control, the FDIC initiated in January 1985 a monthly reporting requirement. Banks are now required to report monthly the dollar amounts of their fully insured brokered deposits and fully insured deposits from other depository institutions (principally banks and credit unions) whenever the sum of these two classes of deposits exceeds 5 percent of the bank's total deposits.[24]

The FDIC has used these reports only for internal supervisory purposes, however, and has not released aggregate statistics based upon them. Consequently, as a part of its continuing coverage of the brokered deposits issue, the Commerce, Consumer, and Monetary Affairs Subcommittee requested access to these reports. This request was refused by the FDIC.

On June 18 the subcommittee then requested the U.S. General Accounting Office to prepare certain tabulations from these reports, based on the information reported for March 31 and June 30, 1985. An important element of this request was that the dollar totals be reported separately for sound and "troubled" banks (i.e.,

---

[23] "New Findings on Brokered Deposits," memorandum to subcommittee Chairman Barnard from Donald P. Tucker, chief economist, April 25, 1985; reprinted as appendix 2.

[24] Banks may not know the insurance status of jumbo CD's placed by brokers. The FDIC therefore instructs banks to assume that all deposits placed by brokers for the account of others are fully insured, for the purpose of this reporting requirement, unless explicitly informed otherwise by the brokers.

BEST COPY AVAILABLE

those with a supervisory CAMEL rating of 3, 4, or 5), in order to provide reliable data on the quantity of insured brokered deposits in the weaker institutions.

Although agreeing (after an initial refusal) to provide the monthly report data to GAO, the FDIC refused for several months to provide GAO with its supervisory ratings of the reporting banks, notwithstanding the GAO's statutory right of access to such information. Because of this problem, the subcommittee amended its request to provide for tabulation of the information on national banks only, based upon the Comptroller of the Currency's supervisory ratings of the national banks, which the OCC provided to GAO with full cooperation.

In November the FDIC finally reached agreement with the GAO for provision of the supervisory ratings necessary for completion of the subcommittee's original request. The results of both sets of tabulations are shown in Tables 1-A and 1-B.

Of particular interest from these figures are the following:

a. The number of banks holding 5 percent or more brokered deposits declined quite substantially between March 31 and June 30, 1985.

b. Fully insured brokered deposits are more heavily concentrated in the sound banks (rated 1 or 2) than in the weaker institutions (rated 3-5), and this emphasis on the sounder banks increased substantially between March 31 and June 30.

c. In the weaker banks rated 3-5 and having less than $1 billion in deposits, the total of insured brokered deposits was only $664 million on March 31, and this declined 20 percent to $529 million on June 30.

C. BROKERED DEPOSITS IN FAILED BANKS, 1982-85

Table 2 contains a summary of the principal statistics concerning brokered funds in failed banks, by year, for the past 4 years. Table 3 lists all 1985 commercial bank failures during 1985, showing the brokered deposits percentage in each.

These two tables illustrate the significant decline that has occurred in the role of brokered deposits in bank failures in 1985, as compared with the earlier years. Of particular interest from these figures are the following:

a. Only 13 percent of the commercial banks that failed in 1985 (15 banks out of 114) had more than 5 percent brokered deposits, compared with 32 percent of the failures in 1984 and 56 percent of the failures in 1983.

b. In terms of total deposits, the failed banks that had relied on brokered funding for at least 5 percent of their deposits accounted for only 15 percent of the deposits of failed banks in 1985 (approximately $400 million), compared with 47 percent ($1.2 billion) in 1984 and 63 percent ($1.9 billion) in 1983.

c. Moreover, the average ratio of brokered to total deposits among the failed banks having over 5 percent brokered deposits was much lower in 1985: on average 15 percent of

COPY AVAILABLE

their deposits were brokered, as compared with 24 percent and 33 percent brokered for the comparable groups of failed banks in 1984 and 1983.

d. Among all the commercial bank failures in 1985, only 2 percent of their deposits were brokered, compared with 15 percent of the total deposits of the banks that failed in 1984 and 16 percent of the total deposits of the 1983 failures.

e. Only four banks that failed in 1985 had obtained more than 15 percent of their total deposits from brokers, compared with 13 of the banks that failed in 1984 and 20 of the 1983 failures. Moreover, these four banks in 1985 were all small, having combined total deposits of only $81 million. This contrasts sharply with the combined total deposits of $670 million among the 1984 failures having over 15 percent brokered funding, and $1.2 billion among the 1983 failures with over 15 percent brokered funding.[25]

D. ROLE OF BROKERED DEPOSITS AMONG SELECTED PROBLEM S&L'S

In response to a request from the Commerce, Consumer, and Monetary Affairs Subcommittee, the Federal Home Loan Bank Board reviewed the cases of several medium to large problem institutions experiencing serious asset quality problems, some of which had made heavy use of brokered funding and some of which had not. The FHLBB was asked to compare these two sets of cases to determine what difference, if any, the use of brokered funding had made.

The FHLBB failed to find any fundamental systematic differences between the cases that relied upon brokered funding and those that did not, except that linked financing arrangements appeared to be present in a couple of the brokered funds case. The FHLBB also reported no evidence that the institutions using brokered funds paid more of their funding than comparably situated institutions paid for nonbrokered funds.[26]

E. FHLBB ENFORCEMENT OF BROKERED DEPOSITS LIMITATION IN INSTITUTIONS WITH LOW NET WORTH

In March 1984 the Federal Home Loan Bank Board issued a rule restricting the acquisition of brokered deposits by FSLIC-insured institutions whose net worth was less than 3 percent of liabilities. The rule prohibited any institution with low net worth from taking brokered funds in excess of 5 percent of liabilities or, if brokered funds were already in excess of 5 percent at March 26, it prohibited any further increase in brokered deposits.[27]

At the request of the subcommittee, the FHLBB tabulated the quarterly brokered deposits growth and other related statistics of the institutions subject to the rule (i.e., having low net worth and

[25] 1983 and 1984 figures are based on Schedule A attached to former FDIC Chairman Isaac's statement of July 16, 1985, for the Subcommittee on General Oversight and Investigations, and on deposit data from FDIC annual reports.

[26] Federal Home Loan Bank Board letter to subcommittee Chairman Barnard, with exhibits, March 4, 1985. These Bank Board findings are described and analyzed more fully in appendix 2.

[27] See footnote 3.

an initial brokered deposits level in excess of 5 percent) for the second through fourth quarters of 1984. The results of the initial tabulations, through September 30, are shown in table 3 of the memorandum in appendix 2.

This table shows that on April 1, 1984, there were 122 institutions having 10 percent or more brokered deposits that were subject to this rule because of their low net worth (many others having brokered funds between 5 percent and 10 percent of total deposits were also subject to the rule but were not analyzed). The table reports, based upon the FHLBB tabulations, that 21 of these institutions violated the requirements of the rule by adding more brokered funds during the next 3 months ending June 30. The table shows, furthermore, that the average rate of brokered funds increase for these noncomplying institutions was very substantial.

Similar results were found for the next 3-month period from July 1 to September 30, 1984. 24 of the 113 institutions having low net worth and at least 10 percent brokered funding at the beginning of the quarter violated the rule by adding more brokered funds, and again the average percentage increase was substantial.[28]

The subcommittee then requested information on the numbers of noncomplying institutions whose noncompliance continued to December 31, and a report on the supervisory agents' efforts to obtain compliance by these institutions. The Bank Board's reply showed that most of the institutions with low net worth that were above 10 percent brokered deposits on April 1 or July 1 and then increased their brokered deposits still further by September 30 remained out of compliance 3 months later on December 31, having failed to reduce their brokered funding even back to the March 31 level. The Bank Board's explanation is that a few institutions had defied explicit supervisory instructions to reduce brokered deposits, but that the majority had increased their brokered funds in this manner "with the knowledge and approval of the supervisory agent." [29]

The widespread granting of waivers by the supervisory agents reported by the FHLBB is interesting because the language of the interim rule in effect at that time did not give the supervisory agents discretion to grant waivers. Their actions suggest, therefore, that they had serious reservations about the wisdom of imposing this 5 percent cap on many of the institutions, in spite of their low net worth. The FHLBB itself appears to have reached the same conclusion eventually because the final rule implemented by the FHLBB in February 1985 does make provision for the supervisory agents to grant waivers.

F. BROKERED FUNDS GROWTH IN PROBLEM S&L'S, MARCH 31 TO SEPTEMBER 30, 1984

The committee's September 1984 report contained statistics on brokered funds growth in both nonproblem and problem S&L's during the first 3 months of 1984, provided by the Federal Home

---

[28] Tabulations based on tables 53 and 54 of exhibit A attached to Federal Home Loan Bank Board letter to subcommittee Chairman Barnard, March 4, 1985.

[29] Federal Home Loan Bank Board letter to subcommittee Chairman Barnard, May 3, 1985, p. 2.

Loan Bank Board. These figures showed extremely rapid brokered funds growth at an annualized rate of over 100 percent on average by the problem institutions.

For comparison, the subcommittee then requested additional data for the next 6 months covering the same groups of problem and nonproblem institutions. The new tabulations showed that brokered funds growth among the problem institutions as a group had completely stopped after March 31. Although some problem institutions continued to add brokered funds, on average the group lost brokered funds at a 20-percent annualized rate in this 6-month period. This occurred in spite of a continued rapid growth of brokered funds among nonproblem institutions.

These results, which are covered more fully in appendix 2, and which occurred in spite of the widespread noncompliance described above with the rule limiting brokered funds growth by institutions with low net worth, suggest that rapid brokered deposit growth can be effectively controlled by supervisory efforts.

III. Findings

A. SUMMARY

The committee finds that sweeping industrywide restrictions on brokered deposits and onerous and duplicative recordkeeping requirements, as proposed by the FDIC and FHLBB, cannot be justified on the basis of the evidence offered. While supervisory restrictions limiting the access of individual problem banks and thrifts to brokered funds, applied on a case-by-case basis, may be an appropriate supervisory tool, and while the potentially harmful effects of linked financing arrangements deserve particular supervisory concern, neither the recent bank and thrift failures involving brokered funds nor any other recent information on the role of insured brokered funds in troubled banks and thrifts demonstrates any need to prohibit or tightly restrict all institutions' access to such funds. Finally, the committee finds that certain key representations on the brokered deposits issue made by senior FDIC officials were not factually accurate and should not be the basis for congressional action.

B. COMMERCIAL BANKS

1. Brokered deposits in recently failed banks

During 1985, brokered deposits were only a minor factor in bank failures, in sharp contrast with the experience of the preceding 3 years, as shown in tables 2 and 3. The following facts illustrate this decline in the role of brokered deposits in bank failures since concentrated supervisory attention began to be directed toward this problem in mid-1984:

a. Only 13 percent of the commerical banks that failed in 1985 had obtained more than 5 percent of their total deposits from brokers, compared with 32 percent of the 1984 failures and 56 percent of the 1983 failures.

b. Brokered deposits were only 2 percent of the total deposits in all failed banks in 1985, compared with 15 percent in 1984 and 16 percent in 1983.

c. Only four banks that failed in 1985 were holding over 15 percent brokered deposits when they failed, and these institutions were all small, having combined total deposits of only $81 million. In 1984, by contrast, thirteen banks with combined total deposits of $670 million had over 15 percent brokered funding when they failed; and in 1983 twenty banks, with combined total deposits of $1.2 billion, failed with over 15 percent brokered funding.[30]

2. Role of brokered deposits in large troubled banks

Large banks (those having over $1 billion in deposits each) hold the vast bulk of the insured brokered deposits in banks. With the possible exception, however, of one large bank found by FDIC examiners to have made problem loans with brokered funding prior to its 1982 examination,[31] no large banks have ever been reported by the agencies as having made abusive use of brokered funding. The committee therefore finds no evidence of any need to curtail the brokered funds activities of the large banks. The following facts provide the basis for this finding:

a. Large banks with over $1 billion in deposits held 80 percent of the insured brokered deposits reported to the FDIC by banks holding at least 5 percent brokered deposits as of March 31, 1985. At June 30, 1985, the large banks held 88 percent.[32]

b. Most of the insured brokered funds held by larger troubled banks (CAMEL rating of 3 or worse) are in national banks, supervised by the Comptroller of the Currency. After careful analysis of examination findings for these institutions, the Comptroller found no evidence that the brokered nature of some of their funding had contributed to their troubled or problem status.[33]

3. Insured brokered deposits in sound banks

Insured brokered deposits are more heavily concentrated in sound banks than in troubled banks, contrary to the assertion of former FDIC Chairman Isaac.[34] On March 31, 1985, 52 percent of the insured brokered deposits reported by institutions having at least 5 percent brokered funding were in institutions with CAMEL ratings of 1 or 2, and this percentage rose to 71 percent on June 30.[35] These figures demonstrate conclusively that insured brokered deposits are not principally being used by weak banks to evade market discipline or regulatory constraints.

---

[30] The number of failed banks exceeding 15 percent brokered funding is of particular interest because 15 percent was the proposed ceiling level on brokered funding embodied in H.R. 107, introduced January 3, 1985, by Congressmen Garcia, Schumer, and Barnard.

[31] As reported in FDIC response to subcommittee inquiry described in appendix 2.

[32] See Table 1-A

[33] See letter of Comptroller of the Currency C. Todd Conover to subcommittee Chairman Barnard, February 8, 1985, in appendix 2 of this report. The concentration in troubled national banks is confirmed by the more recent figures in Tables 1-A and 1-B.

[34] See footnote 10.

[35] See Table 1-A.

4. Individual abuses

There have been and may continue to be individual instances of serious banking abuse by smaller banks using brokered funds, in some cases involving linked financing arrangements with specialized deposit brokers. The continuing occurrence of such individual abuses does not, however, demonstrate that the practice of insured deposit brokerage is itself harmful. It demonstrates instead that responsible bank supervision requires closer attention to the possibility that some individual banks may be tempted to make unsound loans or investments with brokered funds. It also demonstrates that tougher supervisory measures are needed when such unsound lending and investment practices are found.

5. Brokered volume in smaller troubled banks

The total dollar volume of insured brokered funding in smaller institutions reporting more than 5 percent brokered funding was $891 million on June 30, 1985, which was only 12 percent of the $7.3 billion in brokered deposits reported by all such banks.[36] Moreover, only $529 million of this amount was in troubled institutions.[37] To the extent that aggregate data on brokered deposits in troubled institutions has relevance for measuring the magnitude of the problem, this figure of $529 million, rather than the $9 billion figure often cited by former FDIC Chairman Isaac, represents the most appropriate measure of insured brokered funds in institutions potentially subject to some risk of abuse.

6. Linked financing

Although linked financing agreements with deposit brokers have been found in some recent bank failures and have been cited by the FDIC as an abuse that has contributed to the failures, the FDIC has not identified linked financing as per se an unsound banking practice and has not taken regulatory steps to curtail or prohibit this practice generally. The committee finds misleading, therefore, the FDIC's references to linked financing as a contributing cause of certain failures. If linked financing is not a banking abuse when other parties do it, then it cannot be a banking abuse merely because a broker is one of the parties.

7. Recordkeeping proposal

The proposal to require that banks maintain records of the beneficial ownership of all insured brokered funds, while appearing superficially reasonable, was not based on a demonstrated and documented need. The FDIC offered no factual evidence to support its assertions that the present system of brokered deposit ownership records had caused substantial unnecessary costs and delays in settling the accounts of failed banks. The FDIC also offered no indication of having considered the significant added costs the rule would impose on banks and brokers or the disruption it might cause in the secondary market for insured bank CD's. The committee finds that agency rulemaking of this sort, without any demonstration of

[36] Banks under $1 billion in assets hold approximately 37 percent of all deposits in U.S. banks, based on FDIC tabulations of bank call reports for December 31, 1984.

[37] See Table 1-A.

the inadequacy of the present rules or consideration of the significant costs and disruptions that might be imposed on others, was procedurally inadequate and inappropriate, and might have done significant harm.

8. FDIC misrepresentation

Senior FDIC officials, in advocating new regulations and legislation to curtail or prohibit the practice of insured deposit brokerage, did not report accurately the agency's own data on the nature and extent of the problem. Moreover, the FDIC improperly impeded congressional efforts to examine this agency data more closely. In particular:

a. Former FDIC Chairman Isaac's repeated emphasis on the presence of $9 billion of brokered funds in problem institutions never had any meaning as an indicator of the size of the problem, for two key reasons. First, most of the $9 billion was in large national banks whose problem status has never been found to be connected with their partial reliance on brokered funds. Second, it was evident from call reports and (at a later time) monthly reports in the FDIC's possession that a substantial portion of the $9 billion figure was not insured and was therefore not relevant to his policy concerns.[38]

b. In asserting before the Banking Committee's General Oversight Subcommittee that most insured brokered funds are in problem institutions and that sound institutions do not use insured brokered funds,[39] Mr. Isaac did not report accurately the FDIC's own data showing the contrary: Among banks subject to the FDIC's monthly reporting requirement for brokered funds, the bulk of insured brokered funds are in banks rated 1 or 2, as shown in table 1-A below.

c. Mr. Isaac's testimony before the General Oversight Subcommittee that it is very difficult for smaller institutions to grow rapidly without access to brokered funds[40] is directly contradicted by data the FDIC had previously supplied to the Commerce, Consumer, and Monetary Affairs Subcommittee. This data showed many small problem banks (rated 4 or 5 and having deposits of $100 million or less) growing very rapidly without brokered funding, while only a very few such banks grew rapidly with brokered funding.[41]

d. The FDIC's refusal to provide to the General Accounting Office its supervisory ratings of the banks reporting more than 5 percent insured brokered deposits, which the GAO needed in order to analyze the FDIC's monthly report data on brokered funds, appeared to represent an attempt to impede congressional fact finding aimed at evaluating the soundness of the FDIC's policy recommendations on brokered funds. The GAO

---

[38] The Comptroller of the Currency reported that, as of September 30, 1984, $8 billion of this $9 billion total was in a few large national banks, and that only $2 billion of this (approximately 25 percent) was insured (see appendix 2 of this report). The Comptroller's analysis was based in part on call report data on file at the FDIC. More recent monthly reports direct to the FDIC have confirmed this picture of substantially less in insured brokered balances in troubled institutions (see Table 1-A).

[39] See hearing dialogue quoted above in chapter I, section C (footnote 10).

[40] See footnote 11.

[41] See table 4 (page 26) of the 1984 subcommittee report, op. cit. (footnote 1).

has a statutory right of access to such information, and the FDIC had no valid basis for withholding it from GAO for 6 months, from June to November 1985.

C. SAVINGS AND LOAN ASSOCIATIONS

1. Positive role for brokered deposits in troubled institutions

The Federal Home Loan Bank Board, in contrast with the FDIC, has indirectly acknowledged a positive role for brokered deposits in troubled institutions, at least under certain circumstances. This is shown by the numerous approvals that were granted for S&L's with inadequate net worth to exceed the regulatory limit on brokered deposits set by the FHLBB in its April 1984 rule.[42] Of particular note was the FHLBB's approval for Financial Corporation of America to raise $1 billion through brokers in October 1984 when it was in financial difficulty.

2. Ineffectiveness for controlling growth

The FHLBB, again in contrast with the FDIC, has never disputed the committee's earlier findings that problem institutions can and do grow very rapidly without brokered funding, and has now acknowledged that a brokered funds limitation may not be an effective method of limiting excessively rapid growth.[43]

3. Net worth rule

The problem of excessively rapid growth financed with high cost brokered funds, which the FHLBB had previously sought to control through tight restrictions on brokered deposits, should be effectively controlled under most circumstances by the net worth rule that was implemented in March 1985, providing this rule is effectively enforced and is extended or made permanent before its present expiration date of January 1, 1987.

4. Linked financing

The FHLBB has never demonstrated that linked financing is a significant problem among savings and loan associations and has not formulated a general policy against it. Although the existence of a few such cases among small commercial banks suggests that thrifts also may be vulnerable to being pressured into making bad loans by deposit brokers who require them to enter into "linked financing" deals in order to obtain deposits, the committee finds that such problems should be dealt with by supervisory action on a case-by-case basis, or by regulations or legislation directed specifically at the linked financing abuse, and should not provide the basis for general regulations or legislation severely limiting all institutions' access to insured brokered funds.

5. Enforcement

The committee finds that the FHLBB has had significant problems enforcing its rule limiting the brokered deposits of institutions with low net worth, as acknowledged by Chairman Gray in

[42] See footnote 3.
[43] See Chairman Gray's letter of October 18, 1985, op. cit., p. 2 (appendix 1 of this report).

BEST COPY AVAILABLE

his letter of October 18, 1985.[44] A strong and effective enforcement capacity for securing compliance with existing rules and regulations is essential for addressing the problems the FHLBB has had with institutions relying upon brokered funds.

IV. Recommendations

1. Concentrate just on specific abuses

The FDIC and FHLBB should not renew their efforts to impose broad new restrictions on all banks' and thrifts' access to insured brokered funds. They should instead continue to redirect their regulatory attention more narrowly at specific areas of abuse.

2. Linked financing

The FDIC and FHLBB should formulate coherent policies on the issue of linked financing. If they find it to be an unsound banking practice, they should prohibit or restrict it by regulation. If, however, linked financing is not inherently unsound, then they should not criticize the practice when brokers happen to be involved.

3. Deposit diversification

The agencies should consider establishing deposit diversification standards. They should determine whether banks' and thrifts' vulnerability to coercion by deposit brokers who demand linked financing deals is related to how large a percentage of their total deposits they have obtained from each individual broker. If such a tendency is found, they should consider steps to limit every institution's exposure to any one broker, without severely curtailing the entire market in insured deposit brokerage.

4. Recordkeeping

Before imposing potentially burdensome additional recordkeeping requirements for brokered deposits, the FDIC and FHLBB should prepare cost-benefit analyses that compare the expected future dollar savings to the insurance funds with the added costs the new requirements will impose on depository institutions and brokers. These analyses should be based on specific recent failure cases in which excess costs or delays attributable to inadequate brokered deposits records can be documented. The agencies should only implement recordkeeping revisions that can be demonstrated, on the basis of this cost-benefit analysis, to generate savings or provide other quantifiable benefits that exceed the probable costs.

5. FHLBB net worth rule

The Federal Home Loan Bank Board should act during 1986 to extend or make permanent its net worth rule, and should take all necessary enforcement steps to ensure full compliance with this rule throughout the savings and loan industry. These steps are necessary to curtail excessively rapid growth in loans and investments without commensurate additions to invested equity capital, regardless of whether the asset growth is being funded with brokered deposits or with other sources of funds.

---

[44] See appendix 1, pages 4-7 and addendum.

COPY AVAILABLE

TABLE 1-A.—FULLY INSURED BROKERED DEPOSITS IN FDIC-INSURED BANKS REPORTING AT LEAST 5 PERCENT INSURED BROKERED DEPOSITS, MARCH 31 and JUNE 30, 1985 [1]

	March 31	June 30	Net change
Number of banks:			
Number of large banks (deposits $1 billion or more)	147	125	−22
Number of smaller banks (deposits less than $1 billion)	14	16	2
	133	109	−24
Fully insured brokered deposits ($ millions) in:			
All banks	$5,493	$7,295	$1,802
All banks CAMEL-rated 1 or 2	2,838	5,180	2,342
All banks CAMEL-rated 3, 4, or 5	2,655	2,115	−540
All large banks	4,375	6,404	2,029
All smaller banks	1,118	891	−227
Large banks rated 1 or 2	2,384	4,818	2,434
Smaller banks rated 1 or 2	454	362	−92
Large banks rated 3, 4, or 5	1,991	1,586	−405
Smaller banks rated 3, 4, or 5	664	529	−135

[1] Source: Monthly reports to the FDIC (see text), as tabulated by the U.S. General Accounting Office, relying on the FDIC's CAMEL ratings for all banks (including national banks).

Note: All figures exclude brokered balances in institutions whose fully insured brokered deposits were less than 5 percent of total deposits.

TABLE 1-B.—FULLY INSURED BROKERED DEPOSITS IN NATIONAL BANKS REPORTING AT LEAST 5 PERCENT INSURED BROKERED DEPOSITS, MARCH 31 and JUNE 30, 1985 [1]

	March 31	June 30	Net change
Number of banks:			
Number of large national banks (deposits $1 billion or more)	59	46	−13
Number of smaller national banks (deposits less than $1 billion)	9	10	1
	50	36	−14
Fully insured brokered deposits ($ millions) in:			
All national banks	$4,275	$4,762	$487
All national banks rated 1 or 2	2,462	3,119	657
All national banks rated 3, 4, or 5	1,813	1,643	−170
All large national banks	3,848	4,378	530
All smaller national banks	427	384	−43
Large national banks rated 1 or 2	2,216	2,932	716
Smaller national banks rated 1 or 2	246	187	−59
Large national banks rated 3, 4, or 5	1,632	1,446	−186
Smaller national banks rated 3, 4, or 5	181	197	16

[1] Source: Monthly reports to the FDIC (see text), as tabulated by the U.S. General Accounting Office, relying on CAMEL ratings assigned by the Comptroller of the Currency (which may not agree with the CAMEL ratings assigned to national banks by the FDIC, upon which Table 1-A is based).

Note: All figures exclude brokered balances in institutions whose fully insured brokered deposits were less than 5 percent of total deposits.

BEST COPY AVAILABLE

TABLE 2.—ROLE OF BROKERED FUNDS IN FDIC-INSURED COMMERCIAL BANK FAILURES, 1982–85

	1982 [1]	1983	1984	1985
Bank failures	32	45	78	114
Failures having brokered funds at least 5 percent of total deposits	6	25	25	15
Failures involving 5 percent or more brokered funding, as percent of all failures (percent)	19	56	32	13
Average brokered funds percentage among failures having at least 5 percent brokered funds (percent)	26	33	24	15
Deposits in failed banks ($ thousands)	$1,098,172	$3,030,280	$2,476,939	$2,690,346
Deposits in failed banks having 5 percent or more brokered funding ($ thousands)	$702,683	$1,900,749	$1,172,707	$391,871
Deposits in failed banks having 5 percent or more brokered funding, as percent of all deposits in failed institutions (percent)	64	63	47	15
Brokered deposits as percent of total deposits in all failed institutions (percent)	14	16	15	2

[1] 1982 figures are heavily influenced by the failure of the Penn Square Bank, which had $125 million in brokered deposits, much of which was not insured.

Source: Federal Deposit Insurance Corporation

TABLE 3.—BROKERED DEPOSITS IN FAILED COMMERCIAL BANKS, 1985

	Name, location	Date closed	Total deposits ($ thousands)	Brokered deposits ($ thousands)	Brokered as percent of total deposits
1.	Citizens State Bank, Edgerton, WY	1–4–85	$2,539	None	
2.	State Bank of Dannebrog, Dannebrog, NE	1–7–85	3,764	None	
3.	Coast Community Bank, Harbor, OR	1–11–85	8,385	None	
4.	First National Bank, Marlow, OK	1–24–85	26,071	None	
5.	First National Bank, Clarksville, TX	1–24–85	28,559	None	
6.	Steele State Bank, Cherokee, IA	1–25–85	17,682	None	
7.	Citizens Fidelity Bank, Bristol, TN	2–1–85	14,104	$294	2.1
8.	First National Bank, Woodbine, IA	2–7–85	24,927	None	
9.	Farmers National Bank, Erick, OK	2–7–85	15,899	None	
10.	Peoples Bank & Trust Co., Wartburg, TN	2–8–85	20,058	6,400	31.9
11.	West Valley Bank, Woodland Hills, CA	2–8–85	34,499	17,600	51.0
12.	First National Bank, Eads, CO	2–14–85	15,139	None	
13.	Citizens State Bank, Fulda, MN	2–15–85	34,962	None	
14.	Inwood State Bank, Inwood, IA	2–19–85	6,906	None	
15.	Halifax National Bank, Port Orange, FL	3–1–85	35,457	None	
16.	Citizens State Bank, Arapahoe, NE	3–8–85	14,282	None	
17.	Commercial State Bank, Afton, IA	3–8–85	15,401	None	
18.	Taylor State Bank, Emington, IL	3–15–85	4,517	None	
19.	Golden Valley Bank, Turlock, CA	3–22–85	65,325	2,100	3.2
20.	Fidelity Bank of Denver, Denver, CO	3–29–85	27,176	2,400	8.8
21.	The Bank of Hunter, Hunter, OK	4–4–85	2,755	None	
22.	Capistrano National Bank, San Juan Capistrano, CA	4–5–85	41,091	2,500	6.1
23.	State Bank of Alexandria, Alexandria, NE	4–11–85	2,430	None	
24.	First State Bank, Elgin, OR	4–12–85	14,888	None	
25.	South Coast Bank, Costa Mesa, CA	4–12–85	26,658	2,500	9.4
26.	Peoples National Bank, Lampasas, TX	4–18–85	32,884	None	
27.	First National Bank, Springfield, CO	4–18–85	13,211	None	
28.	Peoples State Bank, Odebolt, IA	4–26–85	12,511	None	
29.	First Enterprise Bank, Oakland, CA	4–26–85	31,575	None	
30.	The Bank of Commerce, Chanute, KS	5–2–85	62,594	None	
31.	Farmers State Bank, St. Joseph, MO	5–3–85	45,986	None	
32.	Story County State Bank, Story City, IA	5–9–85	31,186	None	
33.	Bank of Newcastle, Newcastle, OK	5–16–85	26,738	None	
34.	The Energy Bank, N.A., Dallas, TX	5–16–85	24,340	2,800	11.5
35.	Northwest Bank, White Settlement, TX	5–23–85	47,103	None	
36.	Bank of Taylor, Taylor, NE	5–31–85	12,225	None	
37.	Scroggin & Co. Bank, Oak, NE	5–31–85	2,755	None	
38.	Security State Bank, Edgar, NE	5–31–85	5,233	None	
39.	Fairfield State Bank, Fairfield, NE	5–31–85	5,382	None	

BEST COPY AVAILABLE

TABLE 3.—BROKERED DEPOSITS IN FAILED COMMERCIAL BANKS, 1985—Continued

	Name, location	Date closed	Total deposits ($ thousands)	Brokered deposits ($ thousands)	Brokered as percent of total deposits
40.	Bank of Lockesburg, Lockesburg, AR	5-31-85	24,491	None	
41.	First Trust Bank, Lakefield, MN	5-31-85	20,643	None	
42.	Bank of Oregon, Woodburn, OR	5-31-85	99,573	None	
43.	American National Bank, Riverton, WY	6-11-85	35,982	None	
44.	First State Bank, Edna, KS	6-13-85	8,336	None	
45.	Swift County Bank, Benson, MN	6-14-85	37,332	None	
46.	Strong's Bank, Dodgeville, WI	6-14-85	30,156	1,100	3.6
47.	Farmers State Bank, Dexter, KS	6-20-85	3,657	None	
48.	First City Bank, N.A., Oklahoma City, OK	6-21-85	84,367	5,695	6.8
49.	Golden Pacific National Bank, New York, NY	6-21-85	148,678	None	
50.	First Bank and Trust, Tracy City, TN	6-28-85	19,650	None	
51.	Madison Bank, Madison, KS	7-2-85	7,819	None	
52.	First National Bank, Jacksonville, AL	7-5-85	39,663	None	
53.	Crossroads State Bank, Oklahoma City, OK	7-11-85	16,414	2,900	17.7
54.	Eskridge State Bank, Eskridge, KS	7-18-85	9,278	None	
55.	First National Bank, Darrouzet, TX	7-18-85	11,543	None	
56.	Linn County Bank, Linneus, MO	7-19-85	5,087	None	
57.	Gilpin County Bank, Blackhawk, CO	7-19-85	3,461	None	
58.	First National Bank, Onaga, KS	7-23-85	19,684	None	
59.	First National Bank, Glenrock, WY	7-23-85	16,933	None	
60.	Kansas American Bank, Overland Park, KS	7-25-85	22,531	None	
61.	Citizens State Bank, El Dorado, KS	7-23-85	25,846	None	
62.	Riverside National Bank, Houston, TX	8-1-85	16,669	None	
63.	Farmers State Bank, Rising City, NE	8-2-85	11,457	None	
64.	Farmers State Bank, Round Lake, MN	8-2-85	20,567	None	
65.	Mineola State Bank, Mineola, IA	8-6-85	4,828	None	
66.	Security Bank & Trust Co., Midwest City, OK	8-8-85	31,493	None	
67.	State Bank of Farmersville, Farmersville, IL	8-9-85	10,985	None	
68.	State Bank of Herndon, Herndon, KS	8-14-85	5,545	None	
69.	Park West Bank, N.A., Farmers Branch, TX	8-15-85	16,920	None	
70.	The Commercial Bank, Andalusia, AL	8-16-85	75,827	None	
71.	The Bank of Bronson, Bronson, KS	8-23-85	8,585	None	
72.	Missouri Delta Bank, Hayti, MO	8-28-85	7,481	None	
73.	Cardwell State Bank, Cardwell, MO	8-28-85	5,545	None	
74.	Moncor Bank, N.A., Hobbs, NM	8-30-85	115,953	None	
75.	Bank of Loretto, Loretto, TN	9-4-85	24,013	None	
76.	Bank of Clifton, Clifton, CO	9-6-85	10,021	None	
77.	First Security Bank, Dickson, TN	9-12-85	14,751	1,500	10.2
78.	Moncor Bank, N.A., Roswell, NM	9-12-85	24,256	None	
79.	Peoples National Bank of Rockland County, Ramapo, NY	9-13-85	18,522	2,698	14.6
80.	Elba State Bank, Elba, NE	9-18-85	3,562	None	
81.	Sedan State Bank, Sedan, KS	9-25-85	24,285	None	
82.	Western State Bank, Denton, TX	9-27-85	21,428	1,302	6.1
83.	First National Bank, Terral, OK	9-27-85	3,169	None	
84.	Tower Bank, N.A., Hialeah Gardens, FL	10-3-85	14,539	1,200	8.3
85.	Bank of Canton, Canton, OK	10-10-85	17,949	None	
86.	Saratoga State Bank, Saratoga, WY	10-11-85	16,367	None	
87.	First National Bank, St. Joseph, MO	10-11-85	149,240	None	
88.	Farmers State Bank, Afton, OK	10-17-85	9,441	None	
89.	The Early Bank, Early, TX	10-18-85	12,314	None	
90.	First State Bank, Jet, OK	10-18-85	10,953	None	
91.	Farmers State Bank, Kanaranzi, MN	10-18-85	3,568	None	
92.	The Citizens Bank, Ogden, UT	10-18-85	80,615	2,000	2.5
93.	The Aurora Bank, Aurora, CO	11-1-85	14,650	None	
94.	Yellowstone State Bank, Lander, WY	11-1-85	19,393	1,000	5.2
95.	Northshore Bank, Houston, TX	11-8-85	40,018	None	
96.	First National Bank, Teague, TX	11-14-85	26,107	None	
97.	Dill State Bank, Dill, OK	11-21-85	13,694	None	
98.	Farmers & Merchants State Bank, La Crosse, KS	11-21-85	28,392	None	
99.	Decatur County National Bank, Oberlin, KS	11-21-85	12,919	None	
100.	The Clarksdale Bank, Clarksdale, MO	11-21-85	5,771	None	

BEST COPY AVAILABLE

TABLE 3.—BROKERED DEPOSITS IN FAILED COMMERCIAL BANKS, 1985—Continued

	Name, location	Date closed	Total deposits ($ thousands)	Brokered deposits ($ thousands)	Brokered as percent of total deposits
101.	Chester State Bank, Chester, TX	11-22-85	10,060	2,500	24.9
102.	Allen County Bank & Trust Co., Leo, IN	11-22-85	11,024	None	
103.	California Heritage Bank, San Diego, CA	11-22-85	18,575	1,400	7.5
104.	Security State Bank, Broken Bow, NE	12-05-85	6,812	None	
105.	Farmers & Merchants National Bank, Hennessy, OK	12-05-85	26,487	None	
106.	Farmers State Bank of Barry County, Exeter, MO	12-13-85	3,998	None	
107.	Lake National Bank, Lake Ozark, MO	12-13-85	17,525	None	
108.	First National Bank of Lincoln County, Ruidoso, NM	12-13-85	26,311	None	
109.	Farmers & Merchants Bank, Comstock, NE	12-19-85	3,455	None	
110.	The Bank of Panama, Panama, NE	12-19-85	4,312	None	
111.	Farmers State Bank, Sargent, NE	12-19-85	11,098	None	
112.	Princeton State Bank, Princeton, MO	12-19-85	16,976	None	
113.	State Bank of Frost, Frost, MN	12-20-85	6,090	None	
114.	First City Bank, Glendale, CA	12-20-85	27,512	None	
	Totals		2,690,346	59,889	

Source: Federal Deposit Insurance Corporation

BEST COPY AVAILABLE

APPENDIXES

APPENDIX 1

FEDERAL HOME LOAN BANK BOARD,
Washington, DC, October 18, 1985.

Hon. DOUG BARNARD, Jr.,
Chairman, Commerce, Consumer and Monetary Affairs Subcommittee, Committee on Government Operations, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: This is in response to your June 6, 1985 letter in which you raised questions regarding brokered-deposit regulation. As I am sure you are aware, the use of insured brokered deposits by thrifts has been and remains a serious concern of mine. This concern stems from the adverse consequences to thrifts and ultimately the FSLIC, which can result from an excessive reliance on insured brokered deposits. The nature of these adverse consequences will be documented in my responses to your questions. In addition to addressing your various queries, I am providing you with some general information and opinions of the Bank Board concerning the difficulties encountered in the supervisory and enforcement process. Also, information you requested regarding the Beverly Hills case is provided in the enclosure. To assure that each of your concerns is addressed, I have reiterated your specific questions and follow it with my response.

1. "Should we not be looking at the risk to individual institutions and the system from excessive reliance on purchased liabilities of all kinds, rather than just brokered liabilities?"

Yes, we should and we do. Traditionally, persons and institutions wishing to place funds in a savings account have dealt directly with an individual institution. More recently, however, depositors with large amounts of money to invest have begun making use of third parties, or brokers to place deposits for them. Brokered deposits are easily accessed and facilitate the transfer of funds outside the local market. There are, however, considerable risks to the institution associated with a deposit broker. The broker can exercise significant control over a thrift institution if it provides a large share of the thrift's deposits. Holding the threat of fund withdrawal over an institution, deposit brokers can pressure the institution into financing speculative real estate loans and other risky assets. In such cases, thrifts, not the deposit brokers, have experienced huge losses when the developer defaulted on the loans.

Clearly, we are also concerned with the risk to an institution and to the system resulting from an excessive reliance on any purchased liabilities. The establishment of a "money desk" operation

to facilitate the purchase of liabilities outside the local deposit base is not a riskless endeavor. This is due to the potential instability in the liability base generated by the interest rate sensitivity of purchased funds. However, purchasing liabilities through a money desk operation may be less risky than purchasing from a broker for two reasons. First, the money desk approach offers diversification potential. Whereas brokered deposits may be confined to a limited number of large accounts, the money desk approach allows for a vast number of geographically diversified individual depositors. Second, the retained institutional control over the purchase of liabilities through a money desk operation reduces the risk of being pressured into speculative financing arrangements.

Although risks are clearly greater in a brokered deposit versus a money desk situation, I have often said that a much larger issue is at stake. It is my firm belief that the initial and continued purpose of federal deposit insurance is to bolster confidence in the stability of the nation's depository institutions and not the insurance of deposits per se. To this end, the federal insurance regulators need the ability to classify the insurance of accounts so that brokered deposits, insured pools of real estate investments and other misuses of federal deposit insurance can be stopped.

2. "Wouldn't a clamp just on brokered funding, without addressing the larger question of all large-denomination purchased liabilities be ineffective? Wouldn't the aggressive institutions just raise their funds in some other manner?"

I agree that a clamp merely on brokered funding would not be wholly effective from a growth perspective because institutions, especially the aggressive ones, would find other means by which to raise funds. The amount of funds available, however, would be restricted to some degree and reliance upon only a small core of external sources would certainly decline. The internal expertise and control gained by an institution that raises its own funds over a brokered funds situation is certainly a positive result.

The problems associated with the excessive use of brokered funds are well known. Over 50 percent of the most troublesome of the FSLIC's current problem cases involve high levels of brokered funds. I feel that regulatory restrictions on brokered funds are warranted to deal with these problems. As we become aware of additional problems associated with other purchased liabilities, we can take appropriate actions, possibly via the regulatory process, to curb, if not eliminate such vexations.

3. How should "purchased liabilities be addressed in the regulatory system? Should capital (net worth) standards for institutions be based in part on the proportion of large-denomination nonlocal CD's in the liability mix? Should there be liability diversification standards, just as currently there are asset diversification standards? Should heavy reliance on purchased liabilities be a risk factor when assessing risk-based insurance premiums?"

We have already adopted two major regulations that "hit at the heart" of the dangers of excessive liability growth. They are the net worth requirements and the direct investment rule. The net worth requirement inhibits a large increase in liability growth without an increasingly greater capital contribution. This prohibits low net worth institutions from growing too rapidly as they in

many cases must now attract outside capital, which may be difficult or impossible given their precarious financial position. In the case of the unscrupulous operator, who is providing his own capital, the cost of doing business may now rise to a level much less economically attractive to him.

The direct investment rule limits the amount of such investments to a prudent relationship to the institution's capital. Formerly, states such as California and Texas permitted such investments up to 100% of assets. Now that these institutions must seek prior approval if such investments are to exceed 10% of assets, the profitability from the risky use of purchased liabilities has been significantly reduced. In other words, a California state-chartered thrift has much less economic incentive to offer high deposit rates to attract funds from a more regulated market, since now their ultimate re-use of these funds is not significantly different from an institution in the latter market.

I do not feel that the net worth standards should be revised to account for the proportion of large-denomination nonlocal CD's in the liability mix. The nonlocal nature of a CD does not automatically assign it a higher risk factor. The reliability, rather than the location, of the depositor is of far greater concern.

It is conceivable that we could institute minimum liability diversification standards but we would like to keep this aspect of an association's operations as flexible as possible. We might more prudently identify large-denomination purchased liabilities which are known to inherently carry added risk to the FSLIC fund and appropriately base insurance premiums in part upon what would be a predetermined excessive reliance on such liabilities.

4. "Won't the new net worth regulation, which seems to have been designed to provide a supervisory tool for controlling excessively rapid growth, help to control such growth without regard to whether brokered or other funding is involved?"

As you correctly observed, the current net worth regulation should help to control excessively rapid growth without regard to the source of funds used to support the growth. However, our net worth regulation was designed to allow a very generous level of growth so as not to restrict the investment opportunities a growing economy and housing market have to offer. Unfortunately, given the large degree of freedom offered by this regulation, an institution can still experience significant troubles if it largely relies on brokered funds. Specifically, the brokered funds' risks of "linked" financing arrangements (e.g., providing speculative uses for deposits just delivered by brokers) and erratic shifts in liability movements can still overwhelm an institution even within the current regulations.

5. "What purpose would be served at this stage by a general curtailment of brokered funds, given that you already have this other rule to stop excessive growth?"

The curtailment of brokered funds would serve to reduce the high volatility these liabilities represent. Funds received from numerous small investors are less subject to the transitory whims of those received from a very limited number of brokers. Furthermore, the problem of "linked" financing arrangements are minimized.

Brokered funds are not only a risk to the FSLIC, but pose a hazard to other healthy financial institutions. The healthy institutions must compete for funds with these other institutions that can afford to pay more for their funds since they are investing in higher risk, higher yield assets. This strategy known as an "end of game play" is a final attempt for institutions to grow out of their problems. The prudent institution may now find it increasingly difficult to raise funds at a profitable spread in relation to local mortgage rates.

More importantly, these brokers are explicitly taking advantage of FSLIC insurance. Since they are receiving federal deposit insurance for funds they place, they are marketing FSLIC insurance to sell their product. This is not the purpose of the insurance fund and curtailment of their activities would serve to direct the fund to its real purpose—to protect the deposits of small investors who trust their savings and loan institutions, via the Federal Government, to protect their personal savings.

6. "Can you throw more light on the whole issue of supervisory ineffectiveness?"

Our current enforcement procedures may be characterized as remedial, not preventative, which was one of the major reasons for the design of our most recent regulations. Current procedures are dependent upon the circumstances of the particular case—the regulation involved, the severity of the violation, and the quality of evidence to support supervisory action. As you imply, the ability of the Supervisory Agent or others to enforce the regulation or require compliance with the precepts of safety and soundness is also an important factor.

It is our experience that agents generally are not at fault where enforcement difficulties are noted. While the majority of associations comply with supervisory directives, it is a conspicuous minority that simply will not follow directions. An inordinate amount of time is then required to verify that orders have been ignored, and even more time elapses before action may actually be instituted to ensure compliance.

Such behavior can be partially attributed to a number of unscrupulous individuals who have entered the industry over the last few years. They have sought high returns on association investments without regard to statutory and regulatory limitations. When cited, they often plead ignorance or seek exemption. An agent must often be extraordinarily tenacious and aggressive in order to assure adherence to an order by those who seemingly have no regard for the law.

In such cases, even the most competent and aggressive Supervisory Agents may be stymied by an association determined to slow the supervisory process. If an association does not want to comply with a supervisory directive, it may seek an attorney's opinion citing some technicality by which it claims exemption from enforcement. It may hide unauthorized activities. It may engage in any number of transactions by which it may slip out of an unauthorized venture. For example, it may swap properties which, by order of the supervisory agent, are being reappraised.

Unsafe and unsound activities, once discovered, must be proved. Supervisory action may then escalate from letters to management

and directors' meetings to supervisory agreements to cease and desist orders. This process is extremely time-consuming and the problem which stimulated all this action is likely to become all the more severe during this period.

Additionally, there are states where regulation of state-chartered associations by state authorities is very limited. The Board must therefore rely on its Insurance Regulations to inhibit or prevent the practice of unsafe and unsound procedures. Often these regulations have not been adequate to accomplish this goal.

I hope the foregoing responses provide for a greater appreciation of the real problems we face. The following additional information relative to the difficulties encountered at the Board with regard to the enforcement process and the measures we have taken to overcome them.

In the past, some Districts experienced less than ideal working relationships between Examinations and Supervision. The organizational split of these staffs exacerbated this problem. Many examiners felt they were undermined by Supervision when deficiencies they advised management to correct were not aggressively addressed by Supervision. Associations were aware of their ability to "negotiate" examination criticisms and attempts were frequently made to circumvent the examiner and appeal to "higher" levels of authority within the supervisory system. Now that examiners are part of the Bank System, there is one focal point—the District Bank—and such attempts at circumvention should be reduced if not eliminated. Moreover, our Office of General Counsel has been able to more frequently use examination reports as a basis for enforcement action, thus eliminating the perception held by many in the industry that comments by the examiner did not count. Appeal to the Supervisory Agent and beyond without full regard for examiners' comments will no longer likely result in a ruling favorable to the association.

Our legal enforcement staff at the Board has increased substantially under my tenure as Chairman. The expertise of these attorneys is broader and they are working much more closely with the Banks. We have discovered that sending enforcement attorneys to meetings held by Supervisory Agents with associations which are not in compliance is often enough to spur the association to correct its deficiencies. The presence of our enforcement attorneys apparently underscores the seriousness of the matter at hand and game playing is less likely. Of course, since our attorneys cannot be present at all such meetings, this strategy is employable in only the most egregious situations.

The following chart illustrates the increased activity of the attorneys in the Enforcement Division.

Calendar year	C&D orders	Number of ind's removed and/or prohibited	Number of formal settlement agreements	Number of investigations completed	
				Formal	Informal
1980	3	1		6	10
1981	8	2		8	6
1982	13	6		10	10
1983	17	21	5	17	15
1984	13	22	10	20	24

These attorneys have also been active in assisting supervision with informal actions such as resignations, forced stock sales, or the disposal of questionable loans. Their calls, recommending compliance with supervisory directives lest more stringent measures of enforcement be applied, have been particularly effective in the correction of deficiencies.

As previously noted in the responses to your specific questions, the ongoing problem we face in supervision is the tendency of some associations to constantly "play games" in their efforts to avoid compliance with the regulations or with the precepts of safety and soundness. The need to demonstrate, without question, an association's wrongdoing is a tedious, long drawn-out process. The Board is in need of enforcement powers which will allow for swift corrective action. The elimination of delays will provide the basis for more effective supervision. In particular, the passage of legislation providing the Board with the ability to restrict an association's additional growth during the enforcement process, would do much toward attaining an association's cooperation and eliminating contrived hindrances to due legal and regulatory procedures.

We also seek support for legislation which will lessen the need for us to show "substantial" weakening or dissipation of an association's assets. Too many times we have known that enforcement action was needed to cause an association's ill-planned ventures to cease. We have had proof of dissipation or impending insolvency but not in a form considered substantial. As we have looked for additional proof to convince the courts, associations have become more enmeshed in their difficulties and unfortunately, the "substantial" proof needed becomes all too obvious as the institution fails.

H.R. 1680, which will be presented before the House, will lessen the burden of proof needed to institute a temporary cease and desist order. It will also serve to expand the Board's enforcement jurisdiction over individuals so that in instances where someone has had a damaging effect on one association, has since left, and is now working at another association; they may still be held responsible for past wrongdoings at their previous place of employment. This Bill would do much to make our enforcement process more efficient and more effective. Improvements to this process can only strengthen the industry which in turn strengthens the FSLIC fund, and ultimately public confidence in the system.

I appreciate the concern expressed in your letter and trust that the candor and detail with which I have responded will assist you in providing the support we need to develop permanent solutions.

Sincerely,

EDWIN J. GRAY, *Chairman.*

Enclosure.

ADDENDUM

SUPERVISORY EFFORTS RELATED TO BROKERED DEPOSITS AT BEVERLY HILLS SAVINGS AND LOAN ASSOCIATION

A review of correspondence reveals that supervisory efforts to control the level of brokered deposits at Beverly Hills Savings and Loan Association, Beverly Hills, California ("Beverly Hills"), began with an April 30, 1984 letter to the association's board of directors notifying them that the institution's level of brokered savings could not exceed 5 percent of deposits since net worth was less than 3 percent of assets. At that point in time, according to reports filed by Beverly Hills, the association had net worth of 2.2 percent of assets, as of 3/31/84, and brokered accounts equal to 17.5 percent of total deposits. The Supervisory Agent also requested monthly reports on brokered deposits.

In its May 16, 1984 letter to the Supervisory Agent, Beverly Hills requested a waiver of the brokered deposit limitation citing the fact that a significant portion of their brokered funds were controlled through Shearson-American Express and Prudential-Bache, both of which would not permit rollovers of maturing deposits so long as Beverly Hills was in violation of the regulatory limitation on brokered deposits.

In a subsequent letter dated May 30, 1984, Beverly Hills responded to the request for monthly reports on brokered deposits. This letter indicated that the total amount of brokered savings was substantially greater than previously reported. The actual amount of brokered savings was $661 million or 44.6 percent of total deposits as of 12/31/83. This figure had increased to $841 million or 49.3 percent of deposits as of 4/30/84. The reasons for the misreporting are unclear. This letter also contained a number of arguments against the limitation on these deposits and noted that Beverly Hills had exceeded the limitations imposed by the interim regulation based on their attorney's opinion that the 5-percent limitation applied to acquisitions of brokered deposits during any quarter and did *not* limit total brokered deposits. The association also disclosed that a money desk had been established in 1983 and was actively soliciting deposits.

In June 1984 Paul Amir, who had acquired control of Beverly Hills in April 1984, imposed a new management team upon the institution. Supervisory actions at the time were tempered by the fact that the new management team had not participated in the past unsound practices.

On July 3, 1984, the Supervisory Agent sent a form letter to Beverly Hills reiterating the provisions of the interim regulation and forwarding a supply of forms for reporting brokered savings activity with a request that the forms be filed by the 10th of each month for the preceding month end.

On July 12, 1984, the Supervisory Agent approved Beverly Hills' June 26, 1984 request for authority to maintain brokered deposits at its adjusted level as of March 26, 1984 of $890 million. The approval was granted to prevent possible liquidity/cash problems. The Supervisory Agent also requested that Beverly Hills submit,

within 30 days, a formal plan to reduce its level and reliance upon brokered deposits.

On July 30, 1984, the association submitted its plan to reduce the amount of brokered savings. This plan basically provided for the reduction of brokered savings $300-$400 million over a six-to-nine month period. The Supervisory Agent considered the plan acceptable.

The brokered savings report for October 31, 1984 was filed on December 6, 1984. This was the first indication that the association had exceeded the $890 million approved level. Reportedly, Beverly Hills exceeded the $890 million limit by $4 million as a result of a miscalculation in the timing of the runoff of certain brokered deposits. Beverly Hills' president, categorically stated in the December 6 letter that the association would be in compliance with the $890 million ceiling at December 31. On January 8, 1985, the November 1984 report was received which revealed that the association had $937 million in brokered deposits. On January 10, 1985, the Supervisory Agent met with Beverly Hills' directorate to discuss a range of supervisory concerns including brokered deposits. At that meeting the association gave its assurances that it would comply with the brokered deposits regulation. The association claimed that one of its brokers had threatened to withdraw $200 million in deposits in November 1984, and that the association had increased broker deposits to an amount in excess of the $890 million limitation in anticipation of these withdrawals. (It should be noted that the $200 million was not withdrawn until April 1985, shortly after that association announced the preliminary results of its 1984 audit which indicated losses of nearly $100 million.) On January 11, 1985, a request was made for permission to exceed the $890 million limitation in order to replace short-term brokered deposits with long-term brokered deposits. This request was denied.

The December 31, 1984 report revealed that brokered deposits totaled $957 million. As with previous reports this one was filed roughly a month after it was due. Beverly Hills' difficulty in filing timely and accurate reports, including monthly and quarterly financial statements, began after Paul Amir's management team took control in June 1984. The Supervisory Agent became aware that significant recordkeeping and internal control problems existed in late 1984. Despite phone calls from the Supervisory Agent, the accuracy and timeliness reports continued to deteriorate. Serious concern with recordkeeping and controls arose when it was discovered that liquidity deficiencies in November and December 1984 resulted from a failure to post wire transfers.

The January report which was received in early February indicated that brokered accounts were $1,069 million. The excuse given for exceeding the limitation in both December and January was that the broker still had not withdrawn the $200 million in deposits. The association was anticipating that the withdrawal would occur at any time.

On February 26, 1985, the Supervisory Agent rescinded the association's authority to maintain brokered deposits in amounts up to $890 million due to the failure to comply with that limitation. Beverly Hills was also directed to cease soliciting brokered deposits. This order was followed by a Supervisory Agreement dated April

BEST COPY AVAILABLE

15, 1985, which prohibited the association from renewing or replacing brokered funds. Subsequent reports reveal that Beverly Hills did reduce the level of brokered deposits from its reported high of $1,069 million at January 31, 1985. At April 30, 1985, brokered deposits totaled $827 million. The primary reason for the reduction was the withdrawal of the $200 million referred to above.

BEST COPY AVAILABLE

APPENDIX 2

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE OF THE COMMITTEE ON GOVERNMENT OPERATIONS

April 25, 1985

MEMORANDUM

To: Chairman Barnard.
From: Donald P. Tucker, Chief Economist.
Subject: New Findings on Brokered Deposits.

In September of last year, the subcommittee issued a report on the subject of brokered deposits entitled, "Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions" (House Report 98-1112). Because of the possibility that the House will consider H.R. 107 or similar brokered deposits legislation this session, you have directed the subcommittee staff to continue to monitor banking agency data on brokered deposits usage, especially the role of brokered funding in problem and failed banks and thrifts. Major requests for new data and interpretive findings on brokered funding were sent to the three bank regulators on December 19, 1984, and a somewhat different request was sent to the Home Loan Bank Board on January 25. This memorandum summarizes the principal fundings and conclusions from these inquiries.

This memorandum also reports briefly on a recent research paper entitled "Brokered Deposits and Bank Soundness: Evidence and Regulatory Implications" released in November by the Federal Reserve Bank of New York.

It is important to note that the most recent data reflected in these agency responses is from the statistical reports to the agencies as of September 30, 1984 (except that the FDIC's listing of individual bank failures, with brokered funds percentages, is complete through April 10, 1985). The December 31 data for individual institutions was not available at the time the requests were made and would probably not have been meaningful anyway, especially for commercial banks. The agencies' rule to restrict the insurance coverage of brokered funds would have been effective for commercial banks as of October 1 if it had been upheld in the Court of Appeals, and the prospect of retroactive enforcement of this rule back to October 1 seriously impacted the brokered funds activities of commercial banks after September 30. For this reason, December data would not have reflected normal brokered funds usage.

Summary of Findings

In summary the following conclusions can be drawn from this most recent data:

A. Commercial banks

1. Among commercial banks, abusive use of brokered funds is generally limited to small institutions, who hold only a tiny fraction of the total brokered funds in banks. There is no evidence of abusive use of brokered funds by the large billion dollar institu-

BEST COPY AVAILABLE

tions, even though they hold the vast bulk of the brokered funds in banks.

2. The figure of $9+ billion that has frequently been cited by the FDIC as the amount of brokered funds in "troubled" banks (CAMEL-related 3, 4, or 5) has no meaning or relevance as an indicator of the size of the brokered funds problem. As of September 30, $8 billion of this amount was held by 13 or 14 large national banks whose "troubled" classification had nothing to do with their reliance on brokered funding, according to the Comptroller of the Currency. Most of this $8 billion in brokered funds was uninsured anyway.

3. Brokered funding is declining dramatically as a factor in recent bank failures. Failures of banks having 5 percent or more brokered funding declined from 56 percent of all failures in 1983 to 23 percent of all failures in the last half of 1984. In the first 3 months of 1985 (through April 10), the corresponding percentage was 17 percent (see Table 1).

4. For these reasons, there appears to be no current need for the kind of severely restrictive regulation or legislation on brokered funds that the FDIC proposed in 1984 and has continued to advocate in the current session of Congress.

B. Savings and loan associations

5. The brokered funds situation among savings and loan associations is somewhat different than among banks, with more brokered deposits in problem institutions ($11.2 billion) and a substantially greater proportion of the brokered funds among problem institutions (as rated at March 31) being held by small- and medium-size institutions under $1 billion in deposits (see Table 2).

6. During the 6-month period from March 31 to September 30, 1984, brokered deposits in problem institutions rated 4 or 5 as of March 31 declined at a 20 percent annualized rate, at the same time that brokered funds in nonproblem institutions were growing at an 84 percent rate (see Table 2). This appears to confirm the earlier judgment of the subcommittee that the regulators can control excessive brokered funding growth by problem institutions through supervisory means alone, without imposing harsh new regulations or legislation.

7. Tabulations requested by the subcommittee show that during this same 6-month period there was substantial noncompliance with the Bank Board's March 26, 1984, interim rule limiting the brokered funds growth of institutions with low net worth (see Table 3). The rule was not effectively enforced. It therefore appears that even better supervisory control over brokered funds usage, at least among institutions with impaired net worth, can be obtained simply through consistent enforcement of the existing rule, without any need for further regulations or legislation.

8. The FHLBB, at the subcommittee's request, reviewed the cases of several large problem institutions experiencing serious asset quality problems, some of which had made heavy use of brokered funding and some of which had not, to determine what difference the use of brokered funding had made. The FHLBB failed to find any fundamental systematic differences between the cases that relied upon brokered funding for their growth and those that did

not, except that linked financing arrangements appeared to be present in a couple of the brokered funds cases. The FHLBB, also in response to the subcommittee's specific inquiry, reported no evidence that the institutions using brokered funds paid more for their funding than comparably situated institutions paid for nonbrokered funds.

9. The Bank Board's new net worth requirements, effective March 21, 1985, will seriously limit the ability of institutions to continue the rapid growth policies they have followed in the past with brokered funds. It would be reasonable for Congress to await an assessment of the effect of this new rule before concluding that additional restrictions directly on deposit brokerage are needed.

C. New York Fed study

10. The New York Fed research study on brokered deposits, although purporting to establish empirically the need for a brokered funds cap, does not provide meaningful evidence to support a need for further brokered funds regulation or legislation.

Commercial Bank Findings

The subcommittee's most recent inquiry to the bank regulatory agencies was designed to establish the significance of the $9+ billion figure that has frequently been cited by the FDIC as the amount of brokered funds in "troubled" banks (CAMEL-rated 3, 4, or 5).

It appeared from the March 31, 1984, data provided earlier to the subcommittee and reported in the Government Operations Committee report [1] that most of this $9+ billion was probably in large institutions having over $1 billion in deposits, but no large banks have ever been cited by the FDIC as examples of brokered funds abuse. Therefore, in order to determine whether the $9+ billion in troubled banks indicated accurately the magnitude of problems caused by insured deposit brokerage, the subcommittee, in letters dated December 19, 1984, requested the three bank regulators to prepare detailed analyses of the brokered funds activities of all large banks (at least $1 billion in domestic deposits) having a CAMEL rating of 3 or worse and having brokered deposits at least 5 percent of total domestic deposits.

The agencies were asked to report, as of September 30, on the number of institutions meeting these conditions, their total brokered deposits, the percentage of these brokered deposits that were insured, and the average interest rates being paid on brokered funds by these banks. Each agency was also asked to evaluate independently, for the banks under its supervision, whether these banks appeared to be paying abnormally high rates for their brokered funds, and whether the receipt of brokered funding was linked in any of these banks to the particular problem loans or other impaired assets that caused the poor CAMEL ratings.

No state member banks fell into this classification, and hence the Federal Reserve did not provide a substantive response on

[1] "Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions," 52nd report by the Committee on Government Operations, September 28, 1984.

BEST COPY AVAILABLE

these questions. Fifteen national and state nonmember banks, holding a total of $8.1 billion in brokered funds, fell within this classification. National banks rated 3 or worse held 98 percent of this amount (almost $8 billion). Hence the response by the Comptroller of the Currency (dated February 8, 1985, and attached to this memorandum) provides the relevant analysis for virtually all these banks.

With regard to the large national banks that accounted for $8 billion out of the $9+ billion of brokered funds in troubled banks, the Comptroller responded that "we can state for the record that there was no evidence of a systemic problem relating to the imprudent deployment of brokered funds." Recent examinations of these banks have found no evidence that brokered funding was being used specifically to fund speculative loans, although such evidence has been found in several smaller institutions.

The Comptroller's Office found from a survey of the banks involved that they were generally not paying premium rates of interest for their brokered funds, and that only about 25 percent of these brokered funds was insured. In response to the subcommittee's final question, regarding whether these banks might have fared better if some rule limiting the insurance coverage for brokered deposits had been in effect earlier, the Comptroller's response was as follows:

> We cannot infer from any evidence, either historical or current, that these large institutions might not have gotten onto the problem bank list and/or [might have] returned more quickly to a sound status if insurance coverage had not been available for brokered deposits. In larger institutions, insurance coverage is not considered to be a significant factor in brokered funding.

A small portion ($150 million; less than 2 percent) of the brokered deposits in these large banks was in one or more FDIC-supervised banks. The FDIC response to the same questions from the subcommittee also found no significant rate premium being paid for brokered funding. Approximately 50 percent of the brokered funds in these FDIC-supervised banks was insured. Regarding the connection between brokered funding and problem loans, the FDIC concluded that in one of these banks there appeared to be a connection between extensive brokered funding and problem loans between the 1981 and 1982 examinations. Even the FDIC response, however, does not appear to find strong support for new regulations or legislation on brokered funds from the large-bank cases it examined at the subcommittee's request.

On the basis of these reports from the Comptroller of the Currency and the FDIC covering over $8 billion of the brokered funds in troubled banks, it is clear that the figure of $9+ billion that has frequently been cited by the FDIC as the amount of brokered funds in troubled banks has no meaning or relevance as an indicator of the size of the brokered funds problem. With the possible exception of the one institution referred to in the FDIC response, connections between bank problem status and the use of brokered funding have never been found in banks having $1 billion or more in assets, and

yet such large banks account for most of the $9+ billion figure the FDIC continually refers to.

Savings and Loan Association Findings

The subcommittee's recent brokered funds inquiries to the Federal Home Loan Bank Board were designed with three objectives in mind. The first objective was to obtain updated statistical information on brokered funds usage generally from the quarterly reports filed with the Bank Board by all institutions. The second objective was to determine from these same quarterly reports whether the Bank Board has been enforcing its interim rule limiting brokered funds growth by institutions with low net worth. The third objective was to obtain the Bank Board's analysis, based on a study of individual case examples, of what difference it makes whether a problem institution gets into trouble with brokered funds or with nonbrokered funds.

Brokered funds statistics.—The tabulations of brokered funds statistics prepared at the subcommittee's request by the Federal Home Loan Bank Board cover the period from March 31 to September 30, 1984. The tabulations previously reported in the committee report had covered the 3-month period ending March 31.

The previous tabulations had provided separate information on the brokered funds usage of problem and nonproblem institutions, by size, according to the supervisory classifications of the institutions on March 31. The new tabulations examine the more recent brokered funds growth of the same problem and nonproblem institutions as were reflected in the earlier tabulations. This was done by basing the separation between problem and nonproblem institutions on the same classification date, March 31.

The new tabulations show that brokered funds growth among the problem institutions as a group completely stopped after March 31. In the first three months of 1984, as reported in Table 1 of the committee report, brokered deposits grew at an annualized rate of more than 100 percent in problem S&L's, but during the next six months the brokered deposits of the same institutions declined at a 20 percent annualized rate (see Table 2 attached to this memo). The ratio of brokered to total deposits in these institutions likewise declined from 6.8 percent to 5.8 percent. These figures have been corrected for any distortions due to mergers or failures and reflect only the brokered funds changes in operating institutions that have not merged.

There were individual exceptions to this general pattern. Out of a total of 678 problem institutions at the end of March, 13 institutions experienced rapid deposit growth in the next six months funded primarily with brokered funds, and the brokered funds growth of these few institutions was extraordinary, as shown in Table 4, attached. It is important to note, however, that this figure of 13 institutions contrasts sharply with the 49 problem institutions that engaged in rapid growth with brokered funds in the first quarter of 1984 (as shown in Table 5 of the committee report on brokered funds).[2]

---

[2] Rapid deposit growth in this analysis is an annualized rate of deposit growth in excess of 25 percent.

This decline in brokered funds among problem institutions between March and September did not reflect any general decline in brokered funding among S&L's. In nonproblem institutions, brokered funds grew at more than an 80 percent annualized rate during this period (see Table 2). Moreover, it does not merely represent the withdrawal of uninsured deposits by cautious brokers; the dollar total of retail-size ($100,000 or less) brokered deposits also decline during this period in the problem institutions.

It is not possible to determine the cause of this decline among problem institutions. It could be voluntary restraint by the institutions themselves, more effective supervision by the FHLBB, increased caution by the brokers about where they place their funds, or some combination of these factors. Whatever the reason, however, this data would appear to indicate that there is a correcting mechanism already at work in the supervisory system or the market place that calls into question the need for any new regulations or legislation on brokered funding for insured institutions.

Compliance with interim rule.—The FHLBB issued on March 26, 1984, (and then clarified on April 23) an interim final rule restricting the acquisition of brokered deposits by insured institutions whose net worth was less than 3 percent of liabilities. The rule prohibited any institution whose net worth was less than 3 percent of liabilities and whose brokered funds were more than 5 percent of liabilities from increasing its brokered funds liabilities above the level held on March 26, 1984. In order to assess the degree of compliance with this rule, the subcommittee requested statistical tabulations from the FHLBB showing the brokered funds growth, by quarter, of all institutions whose net worth made them subject to the rule.

Table 3 attached to this memo reports the principal results of these tabulations, except that institutions with less than 10 percent brokered funds are not covered. As shown in this table, 21 of the 122 institutions having low net worth and at least 10 percent brokered funds on April 1 added more brokered funds during the first quarter the rule was in effect, and the average brokered funds increase was very substantial. Then in the next quarter, beginning July 1, 24 of the 113 institutions having low net worth and at least 10 percent brokered funds added more brokered funds, and again the average percentage increase was substantial. These figures represent apparent noncompliance rates of 17 and 21 percent respectively in these two quarters, even ignoring the noncompliance by other institutions whose initial percentage of brokered funds was between 5 and 10 percent.

On March 14 of this year, the subcommittee wrote again to the Bank Board requesting further information on these cases of noncompliance, including information on the enforcement steps taken. No reply has yet been received. Pending receipt of this reply, however, it would appear from these figures that there is room for major improvement in the enforcement of existing Bank Board rules.

Finally, it is important to note that enforcement of regulations of this sort is handled by the principal supervisory agents, who are senior officers of the individual Federal Home Loan Banks, and not by staff of the Bank Board in Washington. The severe budget limi-

tations imposed by OMB on Bank Board staffing, about which Chairman Gray has frequently complained, do not affect the staff responsible for enforcing rules of this sort. The budget limitations do affect the examination staffs, but examination staffs generally do not need to be involved in enforcing this rule because the information on compliance by individual institutions is provided through routine quarterly reports.

Differences due to brokered funding.—In order to make some empirical comparison about what difference brokered funding makes, the Bank Board was asked to select 10 or more large problem cases with serious asset quality problems, including at least 5 which had relied heavily on brokered funding and at least 5 others which had made little or no use of brokered funding. The Bank Board's analysis was to describe the asset quality problems of each institution and summarize the supervisory steps taken, provide certain statistics on the growth of brokered and total deposits, evaluate whether the brokered funding used by some of them was more expensive than similarly situated institutions were paying for nonbrokered funds, and evaluate what difference the brokered nature of the funding in some institutions seemed to make.

In response to the subcommittee's question about the cost of brokered funds, the FHLBB reported no direct evidence that the institutions using brokered funds paid more for their funding than similarly situated institutions paid for nonbrokered funds.

To the more important question on how the asset quality problems of the institutions using brokered funds differed from the asset quality problems of the other institutions, the FHLBB response was as follows:

> . . . we have concluded that imprudent, reckless growth can occur without brokered funds. However, we have several known incidents of linkage of brokered deposits to questionable loans and the facility of movement of brokered deposits (as opposed to the use of self-organized money desks, advertising or other funds) provide significant oversight and volatility problems.

In effect, therefore, the FHLBB did not find it possible to document, from the case examples selected by the agency, any systematic differences among large problem institutions related to the use of brokered funding, with the possible exception of certain linked financing arrangements.

It is possible that a case can be made that linked financing arrangements, whereby the bank or thrift institution agrees to make certain loans designated by the deposit broker in return for the placement of a certain amount of deposits with the institution by the broker, are generally undesirable and pernicious, and that such practices should be curtailed by regulation or legislation. But any finding that linked financing practices by deposit brokers are undesirable does not justify general restrictions on deposit brokerage. The Bank Board's comparison of large problem institutions therefore provides no support for new restrictions on deposit brokerage generally.

New net worth requirements.—Brokered funding has typically been used to fund very rapid growth of loans and other invest-

ments by aggressive savings and loan association managements. The Bank Board, in a new rule which was effective on March 21, 1985, has just acted to impose graduated net worth requirements that are higher for rapidly growing institutions than for slow-growing institutions, and the new rule also requires an institution to obtain prior supervisory approval from the principal supervisory agent of its Federal Home Loan Bank before it can sustain a growth rate of more than 25 percent per year. Both elements of this new net worth rule will impose substantial new restrictions on the ability of savings and loan associations to pursue the very rapid growth strategies that have been possible in recent years using brokered funding.

The major impact on brokered funds growth that should be expected from this new rule adds another reason to question the need for additional regulations or legislation directly related to brokered deposits. It would seem appropriate at least to wait until the effect of the new net worth rule and other supervisory steps can be assessed.

New York Fed Study of Brokered Deposits

In November 1984 the Federal Reserve Bank of New York released a research study by Sherrill Shaffer and Catherine Piché entitled "Brokered Deposits and Bank Soundness: Evidence and Regulatory Implications." The principal findings of this study are the following:

1. Cross-section data for 1983 and 1984 show a significant statistical relationship between the percentage of brokered deposits in a bank and financial weakness.

2. Among the 18 insured commercial banks that failed between September 30, 1983, and March 31, 1984, those with relatively more brokered deposits tended to impose a higher relative cost of failure on the FDIC than other banks.

On the basis of these empirical findings, the authors report that "These results suggest a cap on brokered deposits, set in the range of 5 to 10 percent of total deposits, as an effective way of curbing the abuse of brokered deposits while retaining their benefits."

The first empirical finding is very difficult to interpret, and may not support the paper's conclusion, for two reasons. First, the manner in which the authors measure what they call "financial weakness" is subject to serious question. Their "financial weakness" measure for each bank is based on 4 financial ratios of the bank:

(a) loans and leases to total funds;
(b) commercial and industrial loans to total loans;
(c) expenses to revenues; and
(d) total capital to risk assets.

(The first three are taken as indicators of weakness, while the final one is an indicator of strength and is used in the formula with a negative sign.)

Whereas the authors consider the first two ratios to be indicators of weakness, they can also be regarded merely as indicators of aggressive banking practice. High values of these ratios do not per se constitute weakness. The third and fourth factors, on the other

hand, are more direct measures of weakness, but they tend to be correlated with each other because of the accounting relationships between revenue, expenses, and capital and therefore do not represent two independent measures of weakness. Any bank with a low capital ratio will inevitably tend to have a high ratio of expenses to revenues.

The other difficulty with the authors' finding about the association between brokered funding and what they call financial weakness is that they do not examine the direction of causation. The weak institutions (assuming you accept their measure of weakness) may merely have a greater tendency to use brokered funds because they are weak, in which case the data do not show that brokered funding caused the weakness. The authors even acknowledge that "certain other weak institutions [that did not fail] may have been able to grow out of trouble or survive temporary hardship by means of brokered funds." This statement would seem to confirm that their results do not necessarily imply that brokered funds caused the weakness of the weak institutions.

As regards the second finding, about the relationship between the use of brokered funding and the costs of failures to the FDIC, this finding rests on a very small sample of 18 failures, which incidentally excludes the very expensive failure of the United American Bank of Knoxville, in which there were no brokered funds.

Finally, the statistical analysis employed in this study is subject to several technical criticisms that seriously impair its reliability. General Accounting Office staff provided extensive assistance to the subcommittee in evaluating the statistical methodology of the study.

For these reasons, the New York Fed research study on brokered deposits does not provide meaningful evidence to support a need for further brokered funds regulation or legislation.

Attachments.

TABLE 1.—ROLE OF BROKERED FUNDS IN COMMERCIAL BANK FAILURES, 1983–85

	1983 January–December	1984 January–June	1984 July–December	1985 January–April 10
Bank failures	45	43	35	23
Failures having brokered funds at least 5 percent of total deposits	25	16	8	4
Failures involving 5 percent or more brokered funding, as percent of all failures (percent)	56	37	23	17
Average brokered funds percentage among failures having at least 5 percent brokered funds (percent)	26	40	13	23
Deposits in failed banks ($ thousands)	$3,030,280	$1,711,764	$769,175	$461,926
Deposits in failed banks having 5 percent or more brokered funding ($ thousands)	$1,900,749	$776,503	[1] $367,825	$122,824
Deposits in failed banks having 5 percent or more brokered funding, as percent of all deposits in failed institutions (percent)	63	45	[2] 48	27
Brokered deposits as percent of total deposits in all failed institutions (percent)	16	18	6	6

[1] Girod Trust Co., San Juan, P.R., had $279 million in deposits when it failed August 16, 1984, of which $37 million (13 percent) was brokered. The FDIC does not cite Girod Trust as an example of brokered funds abuse, however. The brokered funds it held came principally from local corporate sources, following institutional practices peculiar to Puerto Rico, according to FDIC staff. If Girod Trust is excluded from these figures, then only $88.5 million or 18 percent of the deposits of the 34 other banks that failed in this period was in banks having 5 percent or more brokered funding.

[2] 18 percent excluding Girod Trust.

Source: Listings of commercial bank failures, including amounts of brokered deposits, compiled by FDIC.

BEST COPY AVAILABLE

TABLE 2.—BROKERED DEPOSITS IN FSLIC-INSURED INSTITUTIONS, SEPTEMBER 30, 1984

[Dollar figures in millions]

	Institution Size (total deposits)			
	Small (< $100 M)	Medium ($100 M-$1 B)	Largest (> $1 B)	All
Brokered deposits held by:				
Problem institutions	$1,145	$5,671	$4,385	$11,201
Nonproblem institutions	1,533	5,298	25,035	31,866
All institutions	2,677	10,969	29,420	43,067
Problem institutions as percent of all brokered	42.8	51.7	14.9	26.0
Annualized growth rate of brokered deposits March 31, 1984 to September 30, 1984 (percent):				
Problem institutions	−20.2	−25.4	−13.2	−20.3
Nonproblem institutions	4.7	70.0	93.7	83.7
All institutions	−6.7	10.5	70.7	46.6
Brokered deposits as percent of total deposits:				
Problem institutions	7.2	6.0	5.4	5.8
Nonproblem institutions	2.3	2.3	9.9	5.7
All institutions	3.2	3.3	8.8	5.0

Note: Problem institutions, in the tabulation, are those with a supervisory rating of 4 or 5 at March 31, 1984.

Source: Federal Home Loan Bank Board tabulations, prepared at request of Commerce, Consumer, and Monetary Affairs Subcommittee.

TABLE 3.—FHLBB ENFORCEMENT OF RULE LIMITING BROKERED FUNDS GROWTH BY INSTITUTIONS WITH LOW NET WORTH [1]

	Apr. 1-June 30, 1984—Brokered funds percentage on Apr. 1		July 1-Sept. 30, 1984—Brokered funds percentage on July 1	
	10-25	Greater than 25	10-25	Greater than 25
Number of institutions with low net worth and at least 10 percent brokered funds	59	63	58	55
Number of institutions not in compliance (i.e., low net worth and growing brokered funds)	8	13	11	13
Percentage of noncompliance	14	21	19	24
Average annualized percentage growth rate of brokered funds in noncomplying institutions	332	68	160	84
Average annualized percentage growth rate of total deposits in noncomplying institutions	48	52	44	52
Average net-worth-to-liabilities percentage in noncomplying institutions	1.98	62	−16	47

[1] The Federal Home Loan Bank Board adopted on March 26, 1984, an interim final rule (later clarified on April 23) which prohibited any institution whose net worth was less than 3 percent of liabilities and whose brokered funds were more than 5 percent of liabilities from increasing its brokered funds liabilities above the level held on March 26.

Source: Federal Home Loan Bank Board tabulations, prepared at request of Commerce, Consumer, and Monetary Affairs Subcommittee.

BEST COPY AVAILABLE

TABLE 4.—RAPIDLY GROWING SAVINGS AND LOAN ASSOCIATIONS,[1] MAR. 31 TO SEPT. 30, 1984

	Annualized deposit growth rate (percent)	Annualized brokered funds growth rate (percent)	Brokered deposits as percent of total deposits	Retail brokered deposits as percent of all brokered deposits	Retail brokered deposits as percent of total deposits	Number of institutions	Number of institutions with problem rating, September 1984	Number of institutions with impaired net worth, March 1984 [2]
Problem institutions relying principally on brokered funds:[3]								
Small	122.8	305.4	52.2	78.2	40.8	5	5	1
Medium size	88.0	181.6	42.0	29.4	12.3	6	4	1
Largest	38.9	122.2	34.6	59.6	20.6	2	0	1
Problem institutions not relying on brokered funds:								
Small	73.9	−5.5	16.9	28.8	4.9	52	32	25
Medium size	55.0	−46.2	12.5	44.4	5.6	57	35	29
Largest	30.1	−54.5	9.7	76.2	7.4	4	2	2
Nonproblem institutions relying principally on brokered funds:[3]								
Small	97.8	394.8	34.9	16.3	5.7	18	2	3
Medium size	55.8	288.3	29.4	26.8	7.9	14	3	0
Largest	65.7	146.2	38.7	44.9	17.4	5	2	0
Nonproblem institutions not relying on brokered funds:								
Small	72.2	0.8	6.7	45.8	3.1	244	19	36
Medium size	54.7	19.0	6.8	57.1	3.9	93	12	26
Largest	35.1	79.1	12.5	48.0	6.0	17	2	4

[1] Rapidly growing institutions are those whose annualized rate of deposit growth from March 31, 1984, to September 30, 1984, exceeded 25 percent.
[2] Impaired net worth is a net worth/liabilities ratio less than 3 percent.
[3] Deposit growth was principally from brokered funds if the increase in brokered funds from March 31, 1984, to September 30, 1984, was more than 50 percent of the increase in total deposits.

Source: Federal Home Loan Bank Board tabulations, prepared at request of Commerce, Consumer, and Monetary Affairs Subcommittee.

COMPTROLLER OF THE CURRENCY,
ADMINISTRATOR OF NATIONAL BANKS,
Washington, DC, February 8, 1985.

Hon. DOUG BARNARD, Jr.,
Chairman, Commerce, Consumer, and Monetary Affairs Subcommittee, Committee on Government Operations, U.S. House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: We are pleased to respond to your request dated December 19, 1984 for additional data and interpretive findings regarding the role of brokered deposits in contributing to the problem status of large institutions. In order to respond meaningfully to the Subcommittee's concerns, we utilized the most appropriate resources available to us, including examination reports, discussions with bank and examining personnel, supervisory reporting systems and, in some cases on-site review of bank data. We did not directly contact any brokers since the population included exclusively "problem" banks. Although the market is aware of the problems in most of these institutions, it was felt that inquiries by the regulatory agencies would only serve to foster controversy.

The Subcommittee requested that we respond in terms of a population of banks with the following characteristics: total domestic deposits in excess of $1 billion; brokered deposits in excess of five percent of total domestic deposits; and, a supervisory CAMEL rating of three, four or five. By definition, these banks are large daily takers of funds from a global marketplace. Brokered funds are but one element normally utilized to fund a large bank. Even before any difficulties arose in these banks brokered deposits were used as a regular source of funds depending on rate, maturity, and bank strategy. The banks in this population still utilize brokered funds in much the same manner, that is, as a normal source of funding.

In this population, we could uncover no example where brokered funds contributed to or exacerbated the problems that led to the eventual downgrading of a bank's ratings. In fact, some of the banks' liquidity problems were eased by the prudent and judicial use of brokered funds. In cases where severe problems were evident to the market, access to brokered deposits was severely curtailed. Our findings do not mean to suggest that every bank in every case has developed a prudent strategy to deploy brokered funds. However, for the population of banks defined by the Subcommittee and used in this response, we can state for the record that there was no evidence of a systemic problem relating to the imprudent deployment of brokered funds.

The OCC is concerned about the broader issue resulting from banks' access to a much larger funding base than in the past, including global and domestic markets. While this permits a prudent bank to broaden its funding base and, therefore, theoretically expand its liquidity, occasion may arise where a bank utilizes brokered funds to expand an already weak loan portfolio. Our examination process pays close attention to those institutions that derive a material amount of deposit support from brokered deposits. The examination policy for brokered deposits requires a detailed analysis of the following:

The volume and extent of reliance upon brokered deposits for liquidity;

The extent and reasonableness of written policies;

The bank's ability to repay or replace brokered deposits with other sources of funds;

Abuse in the acquisition or employment of brokered funds.

It is not in the best interests of the banking system to eliminate brokered deposits as a viable source of funds. The regulatory agencies can, however, mitigate the risk by constant monitoring and effective supervision. We can, have and will continue to take enforcement action against any institutions where brokered funds are a problem or may exacerbate existing problems.

I trust our response has assisted the Subcommittee in dealing with the issue of brokered funds. As an appendix we have responded to the specific and thoughtful questions raised in your letter.

Very truly yours,

C. TODD CONOVER,
Comptroller of the Currency.

APPENDIX

1. Number of institutions in this class: Fifteen.

2. Total brokered deposits and retail brokered deposits as reported in the call reports for September 30, 1984:

Total Brokered Deposits—$8,120,945,000.

Total Retail Brokered Deposits—$2,060,862,000.

3. Total brokered deposits held by these institutions on September 30 and December 31, 1983 and March 30 and June 30, 1984:

June 1984—$8,212,301,000.

March 1984—$6,829,010,000.

December 1983—$7,381,397,000.

September 1983—$6,178,611,000.

4. and 5. Estimated amount and ratio of fully insured brokered deposits on September 30, 1984. (also state source for this information).

The total amount of insurance coverage for brokered deposits on September 30, 1984 cannot be accurately determined. Internal records at most of these institutions are not sufficiently detailed to provide the necessary information. However, discussion with bank management revealed that these institutions reported retail brokered deposits to the best of their ability in accordance with call report instructions. The amount of fully insured brokered deposits on September 30, 1984 can reasonably be estimated at approximately $2.1 billion or 25% of total brokered deposits.

6. Estimated median, first quartile measure and third quartile measure of interest rates paid on brokered deposits placed with these institutions during the month of September.

The estimated median, first quartile measure, and third quartile measure of interest rates paid on brokered deposits placed with these institutions during the month of September cannot be reasonably and accurately ascertained. Internal records at these institutions do not adequately segregate rates paid on brokered deposits from other funding rates. However, discussion with examining and bank personnel revealed a range of 10.2 to 11.5%. This range is comparable with rates paid on other instruments.

BEST COPY AVAILABLE

7. Approximate percentages of the total and insured brokered deposits reported in responses to questions two and four that were held by national banks, state member banks and state non-member banks respectively.

Of the $8,121 million in brokered deposits held by these institutions, $7,979 million or 98.3% are held by national banks with the remaining $142 million or 1.7% held by state non-member banks. The estimated amounts of fully insured brokered deposits is $2.1 billion as of September 30, 1984. The national institutions represent 96.4% of the total with state non-member banks representing 3.6%.

8. Do these institutions appear to have paid more for the funding they obtained from brokers (considering both the rate of interest paid and relevant acquisition costs) than representative and sound institutions of comparable size were paying for nonbrokered funding of similar denomination and maturity at that time? What estimate would you place on the cost differential for the institutions using brokered funds, and what is the basis for this estimate?

Market forces largely dictate that financially troubled institutions pay higher rates for their funding than financially sound ones. It is the general perception that this holds true for brokered funding as well as non-brokered funding, especially in the wholesale marketplace where the financial condition of the institution has been disclosed. It should also be pointed out that when these funds are procured in large denominations the total cost is minimized as processing/acquisition costs are tremendously reduced.

The majority of the institutions indicated that the cost of these brokered deposits were cheaper or no more expensive than non-brokered deposits. Our review revealed that none of the institutions covered by your request has been offering or paying premium interest rates to purchase these deposits. Moreover, there is no direct evidence that these institutions could not have obtained comparable funding on similar terms from non-brokered sources. Other sources of funding were available, but, it was easier and more practical to use the brokered funds market in order to obtain the rates and maturity structure needed.

9. Is there any direct evidence that these institutions could not have obtained comparable funding on similar terms from nonbrokered sources? If any of these institutions might have had funding difficulty in the nonbrokered markets, does this appear to have been an isolated phenomenon affecting one or two institutions only or does it appear to have been a problem for most or all of the institutions concerned? What is the basis for this finding?

There is no evidence to suggest that these institutions could not have obtained comparable funding on similar terms. Banks in the population use brokered deposits to lengthen the maturity of their liability structure. Brokered deposits are usually of a longer term than most other funding instruments except local deposits. Rate considerations are only one factor a bank considers when deciding on the appropriate mix of liability instruments. In a falling interest rate environment most banks are reluctant to "lock in" interest rates and will rely more on the overnight market to fund assets. In a rising rate environment banks will want to "lock in" interest rates and issue more term instruments, including brokered depos-

its. Except for the extreme cases where funding is not available at any maturity at any price it is difficult to determine with any precision whether a bank is paying over market for funds since the many different funding instruments differ in rate. We found no case where a bank in the population was paying significantly more for brokered funds merely because alternative funds were not available.

10. Is there any direct evidence in any of these banks linking the receipt of insured brokered funding to the particular loans or other assets whose present impaired status has caused these banks to be classified as "troubled" or "problem" institutions? In other words, were insured brokered funds used directly for the problem loans now on these banks' books? Please report in detail the evidence for any such findings.

According to OCC monitoring systems/reports which have been implemented nationally, tied lending and the use of brokered deposits to fund speculative/problem loans do not appear to be a problem in the larger institutions. September 1984 information revealed that several smaller institutions had used brokered deposits to fund and/or support speculative loan portfolios (i.e., oil and gas credits and real estate construction loans); but none of the institutions covered by the Subcommittee's request was determined to be using brokered funds directly to support the problem loans on its books.

11. To what extent have any of these institutions engaged in tied lending (i.e., lending to parties designated by a broker, as a quid pro quo for the placement of funds with the bank) in connection with their brokered funding? Where tied lending has been present, have the loans made pursuant to these tying agreements contributed to the banks' troubled or problem status?

Brokered funds in this population of banks were primarily derived from major nationwide brokers. There was no evidence of any tied lending arrangements.

12. To what extent have these banks continued to solicit insured brokered funds, and to what extent have the major retail stock brokerage firms continued to place new insured funds in these banks, after they were placed on the "troubled" or "problem" lists?

Banks in the population have continued to solicit brokered funds if available albeit a generally reduced amount. In those institutions where the deposits were used to fund certain loan portfolios the average maturity ranged from twelve to fourteen months. In other instances matched funding was initiated and the maturities were relatively short-term. Discussions with OCC personnel responsible for supervising and monitoring these institutions revealed that several of these banks are curtailing their use of brokered deposits and are making concerted efforts to generate funding from local markets.

13. To what extent can we infer from these findings that these particular large banks (a) might not have gotten onto the "troubled" or "problem" bank lists, or (b) might have returned more quickly to a sound status, if insurance coverage had not been available for brokered deposits?

We cannot infer from any evidence, either historical or current, that these large institutions might not have gotten onto the problem bank list and/or returned more quickly to a sound status if in-

COPY AVAILABLE

surance coverage had not been available for brokered deposits. In larger institutions, insurance coverage is not considered to be a significant factor in brokered funding.

BEST COPY AVAILABLE

ADDITIONAL VIEWS

HON. LARRY E. CRAIG

Having reviewed the draft report, "Federal Regulation of Brokered Deposits: A Followup Report," I have found its findings, recommendations, and conclusions to be consistent with the subcommittee's original report which was approved by the Full Committee on Government Operations on September 25, 1984.

I commend the Subcommittee for following up its initial investigation on brokered deposits. I think it's a good policy and should be done more often.

However, this report has its roots based on information obtained in a hearing conducted over two years ago in the 98th Congress. Many of my colleagues here today were not Members of Congress when the original report was passed by the full committee.

I believe that supporting a report which excluded minority participation could establish a dangerous precedent for future subcommittee and committee action. On the other hand, I will not oppose the report because it is consistent with the subcommittee's earlier findings.

Should a similar situation occur in the future, I think it would benefit all of us if we called a brief hearing to go over the new information and to answer any questions which may arise.

Therefore, I voted "Present" on the Report.

LARRY E. CRAIG.

61-417 (56)

BEST COPY AVAILABLE